

**Property Tax Reform in Hawaii:
Kauai's Unique Inverted Split-Rate Property Tax**

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Abstract

Economic theory suggests that switching from a general property tax to a split-rate tax increases land use efficiency and stimulates urban core development while preserving the environment and reducing urban sprawl. Under split-rate property taxation, land is typically taxed at a significantly higher rate than improvements (buildings). Since the mid-1960s, Hawaii lawmakers have experimented with the split-rate system to effect land use policy. Recently, Kauai County has adopted the unusual practice of taxing improvements at a higher rate than on land. Kauai's "inverted" split-rate property tax provides tax relief to residents who own and occupy modest homes and simultaneously exports taxes to the tourist industry and visitors. This paper chronicles and explains the rationale behind Hawaii state and county experiments with split-rate property taxation.

I. Introduction

Nobel laureate in economics William Vickrey once observed that “The property tax is, economically speaking, a combination of one of the worst taxes—the part that is assessed on real estate improvements...and one of the best taxes—the tax on land or site value.”¹ Property tax reforms are an important part of ongoing attempts on the part of states and localities to raise revenue in efficient ways. In the U.S. most local communities tax real property—i.e. land and improvements— at a single rate. However, a few U.S. communities, most notably in Pennsylvania, have experimented with splitting this rate into two components, levying one rate on the value of the land and another on the value of improvements (Hartzok, 1997; Oates and Schwab, 1997; Schwab and Harris, 1997; and Cohen and Coughlin, 2005). Typically, the tax rate on the value of the land is set significantly higher than that on improvements. Around the world, more than 700 cities use the split-rate property tax system (Cohen and Coughlin, 2005, p. 359).

Economic theory suggests that switching from a general property tax to a split-rate tax increases land use efficiency and stimulates urban core development while preserving the environment and reducing urban sprawl. Furthermore, theory predicts that the split-rate system can achieve these objectives while remaining revenue neutral and minimizing excess burden (Cohen and Coughlin, 2005; Schwab and Harris, 1997).

Hawaii’s state-wide experiment with split-rate property taxation began in the 1960’s. As in other localities where split-rate taxation has been adopted, the legislation, passed in 1963 and repealed in 1977, stipulated higher tax rates on land than improvements. In 1978, the State transferred power to levy property taxes to the four counties. In 2006, Kauai county re-instated a

¹ Quote from Cohen and Coughlin, 2005, p. 359.

split-rate system and adopted the unusual practice of taxing improvements at a higher rate than on land resulting in an “inverted” split-rate property tax. To understand fully the potential effects of such a policy, it is useful to study the circumstances behind its passage. This paper examines the adoption of the inverted split-rate property tax on Kauai since 2006.

Section II describes briefly the Hawaii State Legislature’s passage (in 1963) and implementation (in 1965) of a statewide split-rate property tax and its subsequent repeal (in 1977). Section III examines the different approaches to property taxation among the counties after the transfer of taxing powers from the State in 1978. Section IV describes the events and reasons leading up to the adoption of the inverted split rate property tax system on Kauai in 2006 and the introduction of a property tax reform bill (Bill 2274) in 2008 which proposes to greatly widen the gap between property tax rates on buildings and on land. Section V evaluates the merits of Kauai’s inverted split-rate system. Section VI concludes.

II. Enactment and Repeal of the Split-Rate Property Tax at the State Level

The Pittsburgh Tax Plan, modeled on a similar assessment approach used in Pittsburgh, Pennsylvania, was passed by the Hawaii Legislature and signed into law by then Governor of Hawaii, John Burns in June 1963 (Act 142, Session Laws of Hawaii 1963) to be made effective beginning January 1, 1965. Hawaii Revised Statutes, HRS 242, instituted separate rates of property taxation on land and on improvements. The law provided for real estate to be divided into six categories: residential, hotel, commercial, industrial, agricultural, and conservation. Of these, the first four categories would be taxed according to a split-rate system, but agricultural and conservation lands would be excluded. In addition, rates would be phased in according to a

graded schedule. Over time, the law indeed increased the difference in rates on land and on improvements until the repeal of the Pittsburgh plan in 1977.

As one of just a few subnational governments in the U.S. that have experimented with split-rate property taxation, Hawaii presents an interesting case study. The state of Hawaii is unique in many ways. Geographically, it is the only state that is separated from its nearest neighbor by 2,400 miles and it is one of the smallest states (only Delaware, Connecticut and Rhode Island are smaller). It is the last of the 50 states to achieve statehood, and until the overthrow of Queen Liliuokalani in 1893, it was a functioning monarchy. Some believe that Hawaii's highly centralized form of government today and its extreme concentration of land ownership are legacies of the monarchy. Following statehood (in 1959), the islands were divided politically into four counties. The City and County of Honolulu comprises the entire island of Oahu and the northwestern islands of the Hawaiian chain. Hawaii County covers the entire island of Hawaii. Maui County includes the populated islands of Maui, Molokai, and Lanai. The County of Kauai includes the islands of Kauai and Niihau. Hawaii, Maui, and Kauai Counties are collectively referred to as the Neighbor Islands. While the island (and county) of Hawaii (referred to by locals as the "Big Island") is geographically larger than all the other islands combined, Oahu is by far the most populous (Table 1).

The explosive growth of tourism in Hawaii following statehood greatly augmented the resident population with a sizeable and ever-growing tourist population. In 1960, the resident population of Hawaii was around 630,000, but the *de facto* population of Hawaii (which includes the number of tourists present minus the number of residents temporarily away) exceeded 651,000; for 2000, the corresponding numbers were 1.213 million and 1.338 million, respectively.

The state's population in 1960 was very racially diverse. In addition to whites (202,000 in 1960) and Japanese (203,000), Filipinos (69,000), Chinese (28,200), and Koreans (7000), there was a sizeable native Hawaiian population (102,000) (Nordyke, 1989; State of Hawaii, DBEDT, 2006). Hawaii has been and remains unique among the 50 states for its racial diversity; no single racial group comprises a majority of the state's population.

Table 1. Population and Political Subdivisions in Hawaii: 1960 and 2000

	Land Area (sq. mi.)	Resident Population in 1960 (thousands)	Resident Population in 2000 (thousands)
State	6422.6	632.8	1211.5
Honolulu County			
Oahu	596.7	500.4	876.2
Hawaii County			
Hawaii (Big Island)	4028.0	61.3	148.7
Maui County			
Maui	727.2	35.7	117.6
Molokai	260.0	5.0	7.4
Lanai	140.5	2.1	3.2
Kauai County			
Kauai	552.3	28.0	58.3
Niihau	69.5	.3	.2

Source: State of Hawaii, DBEDT, *2005 State of Hawaii Data Book*.

There are aspects of Hawaii's history and set of background characteristics which are critical to an explanation of how and why the State passed and implemented this rather unusual

experiment with property taxes. Three main factors led to the legislation (in 1963) and implementation (in 1965) of the split-rate property tax law. First, the 1960's were years of astonishing growth in Hawaii's economy. This growth quickly transformed what had been a predominantly agricultural economy based on sugar and pineapple production into a service oriented economy based on tourism and the U.S. military (Hitch, 1992). The split-rate property tax legislation was intended to further this growth by taxing idle land at a premium rate and creating a more open, competitive market for land.

The second important factor underlying implementation of the split-rate system in the 1960's was the high degree of centralization in Hawaii's system of state and local government (Meller, 1992). This centralization is related to the state-level provision of K-12 public education. Public schools in the U.S. are typically funded at the local district level and with significant amounts of local property taxes. However, public K-12 education in Hawaii is provided at the state level. The lack of local education funding in Hawaii obviates the need for local government to levy the high property taxes found in other states. The Hawaii State Constitution also places responsibility for the most costly functions of government at the state level. Thus, the State of Hawaii provides much of the expenditures on welfare, health and hospitals (Tax Foundation of Hawaii, 1969). The state's 1984 Tax Review Commission (p.1) concludes in its analysis of Hawaii's fiscal system between FY1965 and FY1984 that "Compared to other states, Hawaii is fiscally centralized, with state government playing the dominant role. The degree of centralization has increased over time."

Throughout the 1960's and 1970's, Hawaii's state and local governments administered sixteen tax laws. Of these, fourteen were administered by the state government. Only the motor vehicle weight tax and the public utility franchise tax were administered by the four local

counties (Tax Foundation of Hawaii, 1968, 1969a, 1971-1979). The limited powers to raise revenues led to limited responsibilities on the part of local county governments. The centralization of government function in Hawaii enabled the state to adopt a state-wide split-rate property tax system. In contrast, the experiments with split-rate systems on the U.S. mainland were enacted sporadically by a few local governments.²

The third crucial factor in Hawaii's passage and implementation of the split-rate system was political. The Democrats gained ascendancy in the 1960's against a backdrop of years of past Republican rule. The power base of the Republican Party was the Big Five, the consortium of five sugar factors who held most of the economic power and wealth in the islands. The first part of the twentieth century saw a high concentration of wealth, land ownership, and power in the hands of the Republicans. Land in Hawaii was more highly concentrated than in any other U.S. urban area (LaCroix and Rose, 1989). Furthermore, the geographical isolation of the islands precluded any substitutes for land in Hawaii (LaCroix and Rose, 1989). As a result, land in Hawaii has always been valuable and "has always been a political battleground and prize" (Cooper and Daws, 1985).³

In contrast to the mainly Caucasian dominated Republican party, the Democratic party was multi-ethnic and consisted of many Asian immigrants and their children. They came into office promising land reform. This meant "changes in the ownership, taxation, and use of land so as to benefit the ordinary person. And because there was no bigger item than land in Hawaii's

² The degree of centralization in Hawaii's system of state and local government shifted in 1978 when the State Constitutional Convention forced the State to turn over administration of the real property tax to local county governments. Article VIII, Section 3 of the Hawaii State Constitution (see Lee, 1993, pp. 143-144).

³ Also Daws (1968), p. 395.

politics, land reform was one of the biggest items on the Democratic agenda” (Cooper and Daws, 1985).

The Democrats’ platform consisted of three main proposals, one of which was the Pittsburgh Tax Bill. In passing the Pittsburgh Tax Bill, the Democrats wanted to shift a greater burden of taxation to land while reducing taxes on homes, buildings, and productive agricultural land. One of the primary intended effects of the Pittsburgh plan was to force more land onto the market and encourage development (Hawaii State Archives, *Legislative Notes*). By forcing land onto the market, legislators hoped to break up the large land estates and produce a more egalitarian distribution of wealth on the islands.⁴ This political change combined with the unique history of land and power in Hawaii contributed to the eventual implementation of split-rate property taxation.

The arrival of the split-rate system in Hawaii was accompanied by higher average property tax rates in all four counties. In 1963, the state-wide average rate was \$14.75 per \$1000 net taxable property. In 1965, the average rate jumped to \$17.54 per \$1000 net taxable property; the rate on land was \$3.42 cents per \$1,000 net taxable property higher than before the implementation of tax reform while the rate on buildings was \$1.58 higher. However, the gap between the two in Hawaii was nowhere near the five-fold or more difference observed in Pittsburgh (see Table 2); indeed, it was not even as wide a gap as the gap in Pittsburgh before that city embarked on its property tax reform (Oates and Schwab, 1997).

Although tax rates varied among the four counties, with Hawaii County levying the highest rates and Maui County levying the lowest rates, the tax rate on land was only about 11 percent

⁴ The legislature also passed a landmark land reform bill in 1967 known as “mandatory leasehold conversion” which forced large landowners to sell their fee simple interests under leasehold single family homes to homeowners (King and Roth, 2006, pp. 81-82; Mak, 1992).

higher than on improvements for all property types in all four counties, except for industrial properties in Hawaii County where the tax rate on land was nearly 16 percent higher.

In the 1970s, the residential category was further divided into two separate categories: improved and unimproved residential. A single rate applied to improved residential properties while the split rate applied to unimproved residential properties. Where the split rate still applied, the gap between the tax rate on land and improvements had widened, but the rate on land was only 43 percent higher than the rate on buildings in all four counties.

Table 2. Property Tax Rates in Hawaii by Property Type in 1965
(Per \$1,000 Net Taxable Property)

Property Type	State Average			Highest vs. Lowest Amongst Counties	
	Land	Improvements	Ratio	Land	Improvements
Residential	\$18.16	\$16.32	1.1127	\$18.47-\$15.64	\$16.68-\$14.08
Hotel/Apts.	18.39	16.57	1.1098	\$18.86-\$15.64	\$16.97-\$14.08
Commercial	18.37	16.50	1.1133	\$18.83-\$15.73	\$16.96-\$14.15
Industrial	18.21	16.33	1.1151	\$19.84-\$15.99	\$17.14-\$14.39
Agricultural	16.95	16.95	1.0000	\$17.90-\$15.00	\$17.90-\$15.00
Conservation	17.41	17.41	1.0000	\$17.90-\$15.00	\$17.90-\$15.00

Notes: (1) Hawaii County had the highest tax rates and Maui County had the lowest rates for all property types. (2) Section 8 HRS 248-2 requires a single rate to be applied to agricultural and conservation properties.
Source: Tax Foundation of Hawaii, *Government in Hawaii: A Handbook of Financial Statistics* (annual).

The Pittsburgh Tax law survived for twelve years. It was eventually repealed as residents' appetite for growth waned in the 1970's (Mak, 2008, Chapter 3). The advent of statehood in 1959, introduction of jet travel to Hawaii that same year, the liberalization of outbound tourist travel in Japan, and the robust U.S. and Japanese economies had quadrupled tourism in a decade, bringing with it dramatic increases in demand for hotel and tourism-related

workers. With the local population unable to fill this demand, immigration soared. During his successful 1974 campaign for governor, George Ariyoshi argued that “It is irresponsible for public officials to discuss Hawaii’s future in terms of unlimited growth.”⁵

In addition, the state experienced significant problems with implementation following passage of the Pittsburgh Tax Plan in 1963. The Plan was considered by some to be overly complicated, opaque, and inequitable. This is hardly surprising. Indeed, Cohen and Coughlin (2005) describe some of the practical problems encountered in administering a split-rate property tax system. In 1977, opponents of the split-rate structure won and the legislature repealed the split-rate system, re-instituting and gradually phasing in a single-rate system. By FY1982, while rates varied across the four counties, each county levied a single rate to land and improvements and to all classes of property.⁶

III. Return of the Split- Rate Property Tax at the County Level

Repeal of the Pittsburgh Tax Plan in 1977 by the Hawaii State Legislature did not spell the end of the split-rate property tax system in Hawaii. Following the transfer of property taxing powers to the counties in 1978 (Hawaii Revised Statutes HRS 246A-2), each county now sets, assesses, and collects its own property taxes.⁷ In FY 1982, all four counties in the state

⁵ Coffman (2003), pp. 241-244. At Ariyoshi’s urging, the 1977 Legislature also passed a bill requiring a one-year residency requirement for local government employment, a measure that was invalidated by the federal district court.

⁶ The tax rate per \$1000 of assessed value was \$15.23 for Oahu, \$7.50 for Maui, \$17.90 for Hawaii, and \$14.50 for Kauai.

⁷ However, HRS 246A-2 provided that “For a period of eleven years commencing November 7, 1978, the counties shall, by majority agreement of the counties, provide for uniform policies and methods of assessment for the taxation of all real property throughout the State. The policies and methods shall include the assessment, levy, and collection of real property taxes. Upon agreement of the uniform policies and methods to be used for the taxation of all real property, each county shall adopt by ordinance such uniform policy and method of assessment as the real property tax law of the county.”

employed a single rate structure and applied a single county-specific tax rate on all property types. However, by FY1999, three of the four counties—Hawaii, Honolulu, and Kauai—had reinstated some version of the split-rate property taxation. Maui County alone elected to adopt a single rate structure.

Hawaii and Honolulu Counties

Between FY1983 and FY2002 Hawaii County imposed a higher tax rate—approximately 20 percent more—on land for all property types except improved residential and homeowner properties.⁸ Thereafter, it adopted a single rate structure for all properties. Honolulu County implemented a single rate structure, except during a 10-year period between FY1989 and FY1998. During this period, the county set higher rates on buildings for improved residential properties (see Table 3).⁹ This was achieved by reducing the tax rate on land from \$6.56 per \$1,000 of taxable value to \$6.09 and keeping the tax rate on improvements unchanged.

Table 3 shows that rates on both land and buildings fell during the early '90s. This is not surprising given that housing prices on Oahu rose sharply in the late '80s. The tight housing market led to a decline in the number of available units for sale at any given time during this period (ACIR, 1989, p. 239). The run-up in real estate prices is widely attributed to speculative

⁸ In FY 1983, land under single family residential land was also taxed at a higher rate than buildings. Between FY 1985 and FY2002, the land tax rate was held constant at \$10.00 per \$1,000 of net taxable property while buildings were taxed at \$8.50.

⁹ Higher rates on buildings also applied to apartments but only between FY1989 and FY 1991. In FY 1983, Honolulu levied a higher rate on buildings for single and multi-family residential properties and on apartments and a single rate on all other properties.

City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division,

at <https://www.realpropertyhonolulu.com/portal/rpadcms/Reports?parent=REPORTS&code=-1>

Japanese real estate investments.¹⁰ Tax Foundation President Lowell Kalapa recalls that the change in property tax policy on improved residential properties was largely a political “backlash” against the wave of foreign, specifically Japanese, purchases of expensive homes in Honolulu beginning in the late 1980s.¹¹ The University of Hawaii’s Real Estate Research and Education Center found that in one neighborhood, Japanese buyers paid an average of 21 percent over estimated market value. Anecdotally, one Japanese billionaire investor purchased 100 homes in upscale East Honolulu and indicated that his goal was to purchase up to 1,000 homes on Oahu (Mak and Sakai, 1992). Between 1987 and 1990, the median price of single family homes on Oahu rose from \$185,000 to \$352,000—an increase of 90 percent in three years (Mak and Sakai, 1992).

Table 3. Property Tax Rates on Improved Residential Properties in Honolulu
FY 1989-FY1999 (\$ per \$1,000 net taxable property)

	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99
Land	\$6.09	\$6.09	\$4.70	\$3.25	\$3.12	\$3.12	\$3.12	\$3.12	\$3.12	\$3.12	\$3.49
Buildings	6.56	6.56	4.95	4.09	3.92	3.92	3.92	3.92	3.92	3.92	3.49
Bldgs/Land	1.08	1.08	1.05	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.00

Source: City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division at <https://www.realpropertyhonolulu.com/portal/rpadcms/Reports?parent=REPORTS&code=-1>

¹⁰ Others have pointed the finger at supply constraints. U.S. Advisory Commission on Intergovernmental Relations (ACIR) (1989), p.239. The ACIR noted that growth in the housing stock did not keep pace with rising population. Between 1960 and 1978, per capita housing units increased from one unit for every 4 residents to 1 unit for every 3 residents. But the ratio fell every year between 1979 and 1985.

¹¹ The idea to raise property taxes on homes combined with a tax credit to rebate increases to resident home owners was one suggested remedy for unaffordable housing in Hawaii during the early 1990s. Ordway (1993), p. 128.

Kauai County

Kauai County's experiment with split-rate property taxation was somewhat different from that of Hawaii and Honolulu counties. Two destructive hurricanes (Iwa in 1982 and Iniki in 1992) caused massive physical and economic damage to Kauai. Lawmakers on Kauai may have intended to provide fiscal incentives to facilitate reconstruction and generate jobs and income.¹² In any case, between FY1984 and FY2005 land for all property classes was taxed at a higher rate than on improvements for all property classes. However, beginning in FY2006, the county did an about face and levied higher tax rates on buildings than land for residential (single family and apartments), commercial, industrial, and hotel/resort properties. Table 4 presents the structure of property tax rates on Kauai for FY2006.

Table 4. Property Tax Rates in Kauai County: FY 2006(\$ per \$1,000 net taxable property)

<u>Property Type</u>	<u>Land</u>	<u>Buildings</u>	<u>Buildings/Land</u>
Single family residential	\$4.00	\$4.30	1.08
Apartment	6.95	7.95	1.14
Commercial	6.95	7.95	1.14
Industrial	6.95	7.95	1.14
Hotel and Resort	6.95	7.95	1.14
Agricultural	6.95	4.30	.62
Conservation	6.95	4.30	.62
Homestead	4.00	3.44	.86

Source: City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division.

The inverted structure of Kauai's 2006 implementation of split-rate property taxation is, at first glance, puzzling. In the following section, we examine the reasons for its adoption.

¹² The 1982 Hurricane Iwa also struck Oahu but inflicted relatively little damage because it missed the urban core. Kauai took the full brunt of Hurricane Iniki.

IV. Political Economy of Kauai's Unique Property Tax Rate Structure

Beginning in late 1998, property values jumped sharply on Kauai (Youn, 2003; Sommer, June 19, 2004; Scontras, 2009). Between 1998 and 2002, sales of condominiums, residential units and vacant land in Kauai increased by 70 percent (from 798 sales to 1,356 sales) while the dollar volume of sales almost doubled from \$228 million to \$462 million (Youn, 2003). The rise in property values was largely attributed to the boom in resort projects and high-end homes purchased mostly by U.S. mainland buyers seeking second or retirement homes. The mayor of Kauai observed that “We’ve had a lot of construction, but all on the high end.” (Sommer, June 19, 2004) Alarmed citizens sought relief from sharply rising home assessments.¹³ The County established a nine-member Real Property Tax Task Force (RPTTF) whose mission was “to create a tax model which provides predictability, equity, and clarity.”¹⁴ The Task Force noted that in 2003 assessed values of property rose by 12.8 percent and in 2004 rose again by 24 percent. As a result, they recommended the current tax model be altered. The Task Force met and in October 2004 unveiled a series of specific recommendations. It suggested that the base assessed value of properties be established by the average of assessed values between 1999 and 2003. Thereafter, annual increases would be indexed to the general inflation rate (Honolulu CPI-U). 1999 was chosen as a starting date because property prices on Kauai had begun to escalate in late 1998. It also recommended that the eight different property tax classes be reduced to two: (1) “Long-Term Residential” for properties which are occupied by their owners and/or long term tenants; and (2) “General” for all other properties. Tax rates on “Long-Term Residential”

¹³ Following the example of California’s Proposition 13, in 2004 Kauai citizens voted to change the county charter to roll back property tax assessments and capped annual assessment increases on owner occupied homes; the vote was invalidated by the Hawaii Supreme Court in 2007 (See Sommer, October, 19, 2004; Zimmerman, 2007; Supreme Court of Hawaii, 2007).

¹⁴ See http://www.kauai.gov/Portals/0/Finance_RP/RPT_update_041015.pdf

properties would be set at \$2 for land and \$6 for buildings for every \$1000 in assessed value. On “General” properties, the tax rate would be \$4 for land and \$12 for buildings for every \$1000 in assessed value. In sum, buildings would be taxed at rates three times that on land. Exemptions would remain unchanged. The inverted property tax was seen to be a way to provide property tax relief for people who own modest homes and to insulate them against sharply rising land values (Chuan, 2004).

Despite the public’s calls for property tax relief, the draft bill (DB2108) did not receive a public hearing at the County Council because council members felt that it would undermine the Council’s taxing authority (Finnegan, 2008). But the rising chorus of demand for action could not be ignored by Kauai lawmakers (Schaefer, 2005). The County Council initially enacted a temporary fix, capping annual property tax bill increases on homes owned and occupied by residents at two percent, and six percent for residents who put their second homes into long term rentals (Eagle, June 2, 2008). Keeping rates on buildings and improvements constant, the mayor proposed and the Council reduced tax rates on land for almost all properties.¹⁵ This resulted in a rate structure that imposed slightly higher tax rates on buildings than on land for residential, commercial, hotel/resort, and industrial properties (Table 5).

The relatively higher tax rates on buildings and improvements automatically shifted a greater share of the overall property tax burden to hotels/resorts and apartments from other property types. In FY2006, 75 percent of the taxable value of “hotels/resorts” and nearly 73

¹⁵ County of Kauai, Department of Finance News Release, May 6, 2005. The property tax rate on land under single family homes was reduced by 22.2 percent from \$5.20 per \$1000 value to \$4.00, and by 15.2 percent from \$8.20 per \$1000 value to \$6.95 on land under apartments, commercial, industrial, and hotel/resort properties. Tax rates on conservation and agricultural lands were also reduced—by 14.2 percent and 8.6 percent respectively—but they remained higher than the rates on buildings. The mayor explained that he wanted to provide tax relief to all property owners and not just homeowners who benefited from the two percent cap earlier. There was no mention of the desire to shift more of the tax burden to hotels/resorts.

percent of the taxable value of “apartments” (which comprised of non-owner occupied units in multi-unit residential buildings, condos and timeshares) were in improvements; by comparison, improvements comprised less than one-third of the taxable value of all other property types and less than 25 percent on single family residential properties.

In the interest of longer-term property tax reform, the Council appointed an eight-person Real Property Tax Committee (RPTC) to study and recommend a durable solution. Following nearly a year of deliberation, the RPTC proposed a real property tax reform package which the mayor sent to the County Council in May 2008 (The County Council of Kauai, Bill 2274).

Bill 2274 (2008) abolishes the temporary measures enacted in 2005, including the popular two percent cap on owner-occupied homes. It replaces them with a “revenue neutral” package of proposed changes including one key proposal from the 2004 Kauai Property Tax Task Force, namely, a 3-to-1 ratio of building to land tax rates¹⁶; the bill also raises dramatically the amount of exemptions for resident homeowners to among the highest levels in the state (Eagle, July 10, 2008)¹⁷. Eric Knutzen, the county facilitator to the RPTC, explained that “We’re putting the emphasis and taxation burden on the building side. The improvements on the land are really what drive the usage of county services.” (Eagle, July 10, 2008, p. A6) In other words, the plan attempts to maximize efficiency by taxing according to use of county services.

¹⁶ The 3 to 1 ratio of proposed tax rates is not locked into the bill and can be changed at any time by the council.

¹⁷ For example, the exemption for homes owned and occupied by residents would rise from \$48,000 for a primary residence to \$300,000. The \$300,000 would be applied to the building value. For those 60 and older, the exemption would rise from \$96,000 to \$325,000 and the current exemption of \$120,000 for residents age 70 and older would rise to \$350,000.

Table 5. Current vs. Proposed Property Tax Rates (\$ per \$1000 net taxable property)

Property Classification	Current		Proposed	
	Building	Land	Building	Land
Single Family Residential	\$4.25	\$3.95	\$10.50	\$3.50
Apartment	7.90	6.90	10.50	3.50
Commercial	7.90	6.90	10.50	3.50
Industrial	7.90	6.90	10.50	3.50
Agricultural	4.25	6.90	10.50	3.50
Conservation/Resources	4.25	6.90	7.50	2.50
Hotel & Resort	7.90	6.90	11.25	3.75
Homestead	3.44	4.00	6.00	2.00

Source: County of Kauai, *Proposed Real Property Tax Improvements* (2008), p. 22.

In addition, the bill reduces the number of classifications from eight to four: (1) residential, which includes owner-occupied homes and long-term affordable rentals; (2) resource lands—which include conservation lands and “farmsteads” principally used for food, fuel, or fibre production; (3) “general”; and (4) resort. Properties under the resort classification are expected to bear the brunt of the change as they potentially have to pay the highest tax rates and the 3-1 split ratio also hits them harder than any other class of property because of their higher capital (structure) intensity. The rationale for this policy is based on a report by green economist Kenneth Stokes (2007) of The Kauaian Institute. Stokes’ report finds that visitors to Kauai account for disproportionate shares of the county’s water, electricity usage, sewage and solid waste discharge (Eagle, August 26, 2008). The RPTC notes that though proposed tax rates on hotels and resorts are now much higher, they are still below those in other counties.

Table 6 shows the winners and losers of the proposed changes. Under Bill 2274, tax revenue from the residential category is expected to fall by an average of 31 percent with its share of total annual county tax revenue falling from 16 percent to 11 percent while the hotel/resort classification’s tax bill would increase by 24 percent and its share of total revenue rise from 19 percent to 23 percent (Table 6). The proposed change amounts to a \$3.75 million

per year in additional tax revenues from the 3,595 parcels in the resort category¹⁸ and a \$4.08 million decrease on the 11,125 parcels in the residential category.¹⁹

Table 6. Revenue Implications of Bill 2274 vs. Current System

Property Type	# of Parcels	Revenue increase (+) or decrease (-)	% Change	% of Total Revenue	
				Current	Proposed
Residential	11,125	-\$4.081 million	-30.72%	16.14%	11.00%
Resource lands	1,077	- .740	-64.67	1.39	.48
General	13,695	+ 2.461	+ 4.73	63.21	65.10
Resort	3,595	+ 3.748	+23.66	19.26	23.42

Source: County of Kauai, *Proposed Real Property Tax Improvements*, (2008), p. 24.

The amount of tax revenue due from the resort class could be much higher if another proposal—to levy taxes on resort properties based on actual use rather than on zoning—is approved (County of Kauai, *Proposed Real Property Tax Improvements*, 2008, p. 20; Eagle, June 2, 2008). This proposal is intended to catch unregistered vacation home rentals whose owners have been paying residential property tax rates. The county recently discovered that of the 1050 homes advertised on-line for rental as vacation homes, only 125 were registered and paying the resort property tax rate. Under Bill 2274 all transient accommodation units would fall under the resort category regardless of zoning.²⁰ If the county taxes those units as resorts, it could raise an additional \$3.03 million in property tax revenue (Eagle, July 10, 2008, p. A6). The chairperson of the Hotel and Lodging Association Kauai Chapter spoke out in favor of the change to require

¹⁸ The 1,629 hotel and resort condominium units would see an increase of \$1.63 million or \$1,001 per unit per year; the 1,841 timeshare units would see a \$2.1 million increase or \$1,142 per unit per year, and the 125 registered vacation rental units would see a \$13,321 increase (Eagle, August 26, 2008).

¹⁹ Commercial businesses (e.g. retail stores) can expect a 12 percent decrease in property taxes while industrial businesses can see a 10 percent drop in taxes. Overall, the “general” category should see an increase in property taxes of 4.7 percent.

²⁰ In early, 2008 the County Council passed a new ordinance prohibiting new single family transient vacation rentals outside designated visitor destination areas (Eagle, February 1, 2008).

vacation rental homes to compete on a level-playing field with other types of visitor accommodation units but was against the 3-1 building to land tax ratio (Eagle, August 26, 2008).

In September 2008, the Council decided to defer Bill 2274 because it could not muster sufficient support to pass it. Opposition to the proposed bill came from diverse groups. The resort community argued that the 3-1 split ratio would reduce the incentive for them to investment in their properties and would harm their competitiveness in the long run (Eagle, September 5, 2008). Homeowners were apprehensive about the elimination of the two percent cap on property tax bills because they liked the “ security and predictability” of the cap (Eagle, August 22, 2008; August 19, 2008)²¹. Many residents who testified at the bill’s public hearings and workshops wanted the council to devote more time to study the proposals to make sure that it would not have negative unintended consequences. (Eagle, September 20, 2008). Because the potential gains and losses to different stakeholder groups are so large under Bill 2274, it may be difficult to achieve the political agreement needed to pass the bill.

V. Kauai and Anti-Development Politics

It is not unusual for governments to design their tax systems to export taxes to nonresidents (Gade and Adkins, 1990). These policies are efficient if tourists are made to pay for public services they consume while visiting their destination (ACIR, 1989, p. 192 and p. 258). Similarly, higher tax rates on building values are efficient if demand for county services is more closely correlated with building values than with land values.

In Hawaii the state government controls most of the taxing powers while the counties bear most of the cost of public services consumed by tourists (ACIR, 1989). An earlier study

²¹ But the councilman who introduced the two percent cap in 2005 indicated that it was time to repeal the measure due to its inequity (Eagle, August 19, 2008, p. A5).

(State of Hawaii Office of Tourism, 1978) showed that while tourists to Hawaii more than paid for the state government services they consumed through its taxes and fees, the counties were not readily able to recoup tourism induced service costs from their own taxes. The property tax is not the best tax handle to export taxes to tourists.²² However, under Hawaii's highly centralized fiscal system, it is the only one open to county discretion.

Kauai's unique property tax approach in taxing building values more heavily than land values provides property tax relief to owners of modest homes and simultaneously exports taxes to nonresidents. While this may reduce the incentive to invest in more hotels and other structures in the county resulting in less income on Kauai, residents appear willing to pay this price. It is the willingness of Kauai residents to pay this price that allowed the passage and implementation of the unique inverted tax structure. Among Hawaii's residents, the citizens of Kauai have historically been the least supportive of tourism growth despite the fact that since the 1980s Kauai residents have had the second lowest per capita income among the four counties (State of Hawaii, 2008, Table 13.10). The Hawaii Tourism Authority's *2006 Survey of Resident Sentiments on Tourism in Hawaii* shows the following distribution of responses to the statement about more hotel development (Marketing Trends Pacific Inc. and John M. Knox & Associates, 2006).

²² The most readily exported "tourist tax" is the hotel room tax (Mak, 2006).

Statement: Even if more visitors come, I don't want to see any more hotels on this island.

	<u>Oahu</u>	<u>Maui</u>	<u>Hawaii</u>	<u>Kauai</u>
Strongly Agree	45%	50%	38%	58%
Somewhat Agree	21	21	18	14
Somewhat Disagree	15	8	9	10
Strongly Disagree	14	19	32	17
Don't Know/Refused	5	3	3	1

In 2006, the Kauai County Council passed a resolution not to support any further zoning changes for resort development (HTA, 2006, p. 16). The County Council also supported efforts to reduce the density of visitor-related projects that had already received approval (HTA, 2006, p. 16).

In the 1990s, the residents of Kauai successfully thwarted the State Department of Transportation's plan to extend the main island's airport runway to accommodate jumbo jets that would have facilitated direct flights to Kauai from the U.S. mainland and Japan.²³ In 2004, following a fight that lasted 28 years, a group of North Shore residents successfully obtained National Register of Historic Places designation for a 10-mile stretch of highway thus locking in place 13 single-lane bridges and making it impossible for large tour buses and trucks hauling construction equipment to get to the North Shore (Sommer, April, 2004).²⁴ In 2007 a group of Kauai protesters stopped a private ferry company—the Hawaii Superferry—from offering the

²³ Fujii, Im and Mak (1992). Maui island residents were also successful in defeating the State Department of Transportation's plan to extend their island's airport runway (Blackford, 2001, p. 190).

²⁴ High end homeowners reportedly hauled in their construction equipment and materials by barges and tugboats.

only inter-island ferry service between Oahu and Kauai.²⁵ Dayton and TenBruggencate (2007) suggest that the Superferry incident was not just a protest by a minority of Kauai residents but the result of majority anti-tourism sentiment. Other high profile cases of stymied development in Kauai county include stalled resort development at Nukolii in the 1970s and 1980s (Cooper and Daws, 1985) and boating on the Hanalei River beginning in the late 1980s (Mak, 2008, Chapter 6)²⁶. The late Kauai County Mayor Bryan Baptiste acknowledged that “Kauai has had a tendency to put a lot of barriers in front of development.” (Youn, 2003).

VI. Conclusion

In the 1960s and until the state government was required by constitutional amendment to turn over the property tax to the counties, Hawaii lawmakers adopted a state-wide split-rate property tax system in which land was taxed at a higher rate than improvements. This policy satisfied political goals of the period: namely, to promote economic growth and effect land reform. Legislators approved this early experiment with split-rate property taxation in Hawaii at a time when economic growth was highly desired and when residents supported “highest and best use” principles of land use. Fourteen years later, the plan was repealed when high levels of growth became less desirable and urban planning shifted toward greater use of green and open-space principles.

Recently, Kauai County adopted the highly unusual practice of taxing improvements at a higher rate than land. With only the property tax under its control, Kauai employs this “inverted” split rate property tax to provide tax relief to residents who own and occupy modest

²⁵ Tizon (2007). An extensive coverage of this controversy, including a time line beginning in 2004, can be found in the October 10, 2007 issue of the *Honolulu Advertiser*.

²⁶ And continues today.

homes and simultaneously to export taxes to the tourist industry and visitors. As in the statewide split-rate system of the 1960's and 1970's, the imposition of the system in Kauai today is also driven by political aims: namely, tax relief for residents at the expense of tourists and economic growth.

Because the rate differences on buildings and on land are small, the current system provides a modest amount of tax relief to resident homeowners. It penalizes hotel/resort owners and tourists (to the extent that taxes on improvements are at least partly passed on), though not by much given the modest size of the local property tax burden in a state where property taxes play a relatively small role in financing state and local public services. Anti-development groups are presented a tax system that is, at least on the surface, anti-development.²⁷ Pro-development groups recognize this system is not in their best economic interest because of the potential loss of income. However, they accept the outcome in exchange for assurances of lower property taxes as partial compensation. As a result, the current system achieves political equilibrium. The unique inverted rate structure in Kauai is thus made possible by the unique existence of sizeable anti-development, anti-growth factions in the local county government. Without these forces, the political equilibrium would be quite different.

An interesting next question is what will happen to this stable equilibrium if the economy enters a sharp downturn? Historically, Hawaii lawmakers have chosen to change the split-rate structure according to the political realities and goals of their time. Thus a sharp enough downturn in the economy is likely to shake up the political equilibrium and lead once more to changes in the rate structure in Kauai.

²⁷ While not publicly discussed, the social and political implications of rapid population growth fueled by economic growth cannot be ignored. Newly arrived residents, who are disproportionately Caucasian, may be seen as a potential threat to the county's ethnic distribution of political power and social harmony (Mak, 2008, Chapter 8). Hence the desire to dampen growth.

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