GRASSROOT
INSTITUTE OF HAWAII

March 17, 2021
12 to 2 p.m.
Videoconference

To: 2020-2022 Tax Review Commission
Elizabeth Giesting, Chair
Alton Miyashiro, Vice Chair

From: Grassroot Institute of Hawaii
Joe Kent, Executive Vice President

Comments Only

Dear Chair and Commission Members:

The Grassroot Institute of Hawaii would like to provide information regarding Hawaii state tax policy.

Introduction

First off, we need to recognize that both Hawaii's economy and its state budget have long been headed in an unhealthy fiscal direction. This is due to policies that increased the state's levels of taxation, spending and debt, which put Hawaii's economy in a weakened condition even before the Great Lockdown Crash of 2020.

Since March 2020, when the coronavirus state and county lockdowns were imposed, Hawaii's economy has worsened significantly. Yet the policies of tax, spend and borrow persist. These policies will not achieve the economic growth — or even the stability — Hawaii needs to recover and even excel after the lockdowns are lifted. Instead, our policymakers need to focus on incentivizing growth and prosperity — through lower taxes, fewer unwarranted regulations and greater opportunities — and thereby organically generate the tax revenues the state needs to meet its obligations to the public.

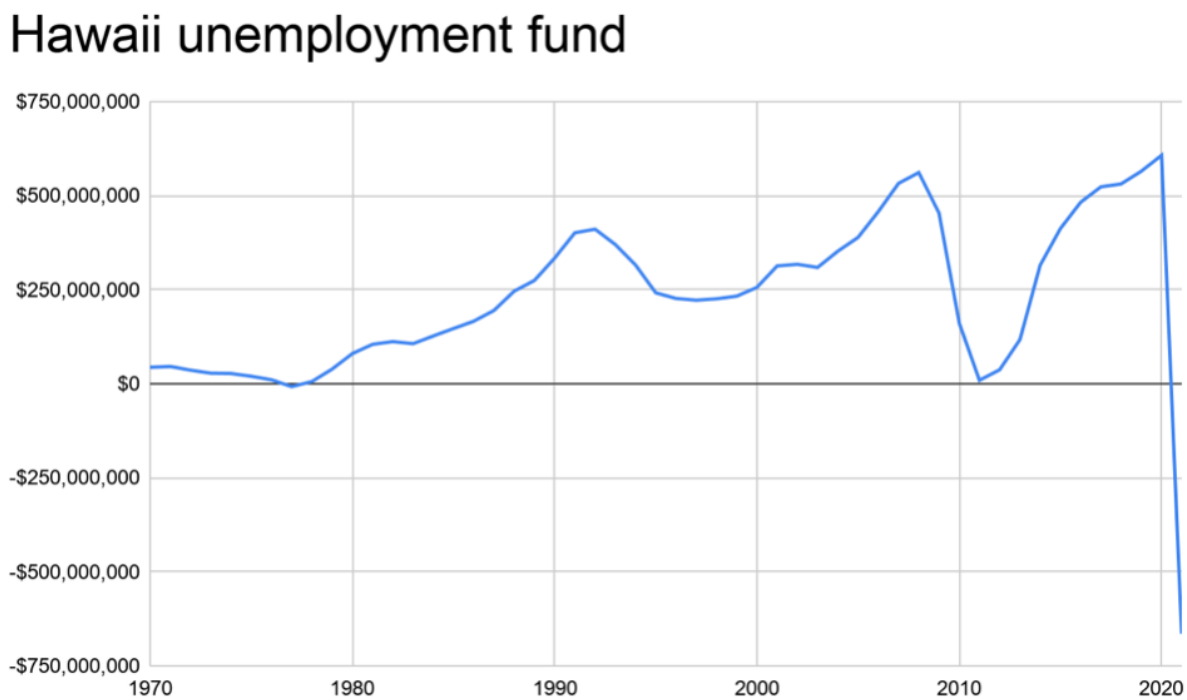
Hawaii's economy is fragile

How fragile is the condition of Hawaii's economy?

Hawaii has the highest unemployment rate in the nation at 10.2%.[1] In 2020, the state's unemployment rate averaged second-highest nationally at 11.6%, behind Nevada at 12.8%.[2]

[1] "Unemployment Rates for States," Bureau of Labor Statistics, March 15, 2021.
[2] "Unemployment Rates for States, 2020 Annual Averages," Bureau of Labor Statistics, March 3, 2021.

This massive unemployment caused by the lockdowns on a tourism-dependent state caused the unemployment fund to drain faster than ever witnessed in the state's history, prompting the state to borrow $700 million from the federal government to pay for unemployment insurance benefits.



"Annual Evaluation of the Hawai'i Unemployment Compensation Trust Fund," Hawaii Department of Labor & Industrial Relations, December 2019, p. A-6. See also, "UI Budget," U.S. Department of Labor, Employment & Training Administration, Nov. 10, 2020.

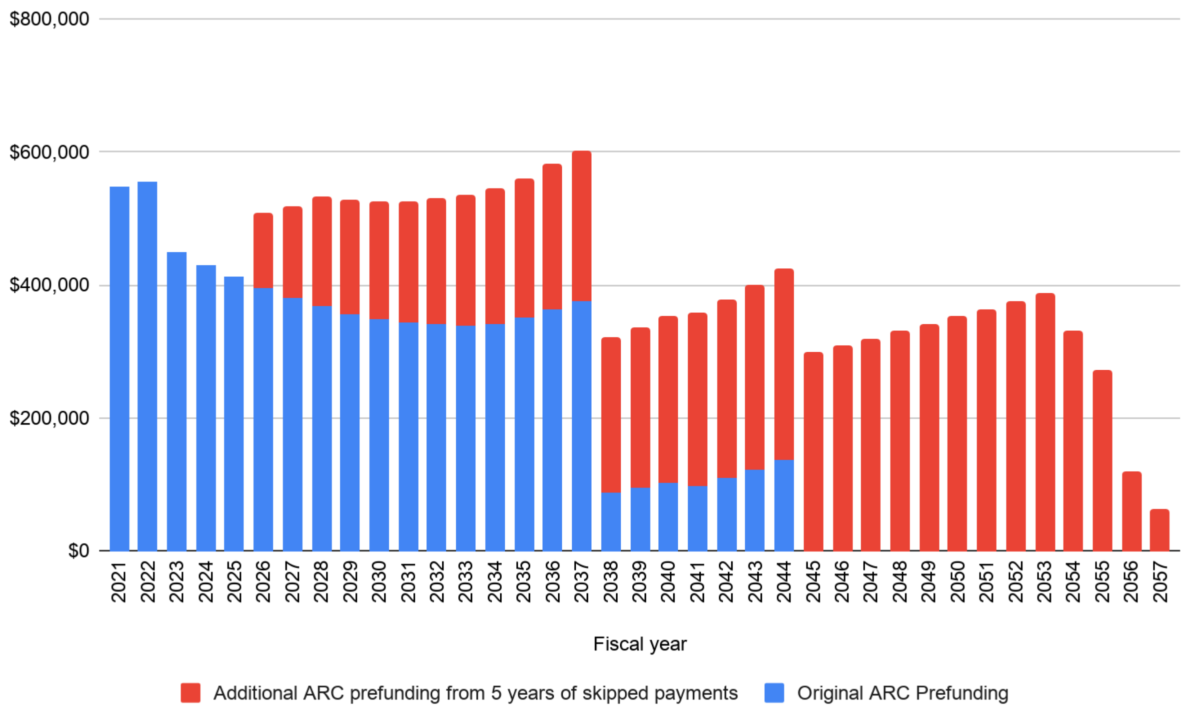
Private sector businesses would typically be on the hook to pay back the $700 million loan for the unemployment insurance fund,[3] but state legislators are choosing to pay back that loan instead, though it is a substantial expense for the state.[4]

In addition to that debt, Gov. David Ige borrowed $750 million from the bond market to fund payroll expenses, but the money needs to be paid back by 2025.[5]

Lawmakers are also planning to skip prefunding the Hawaii Employer-Union Health Benefits Trust Fund, which could save $2 billion in the short run but add $8 billion of debt over the long-term.

[3] "Civil Cafe: Legislative Update," Honolulu Civil Beat, March 10, 2021, 13:20.
[4] Ibid.
[5] "State of Hawaii," Hawaii Department of Budget and Finance, Oct. 21, 2020, p. 2.

Original Annual Required Contributions (ARC) for prefunding + additional ARC prefunding from 5 years of skipped payments (in thousands)

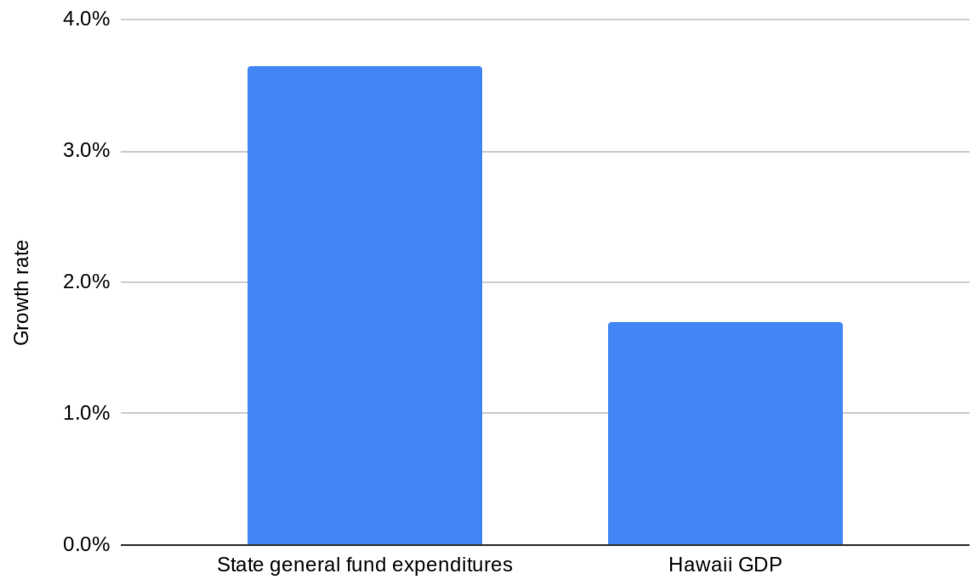


"Grassroot Institute of Hawaii analysis of county ARC increase from deferral of 5 years of prefunding," Grassroot Institute of Hawaii, Jan. 11, 2021. Note: This graph shows the additional amount of annual required contributions required to make up for the deferred $1.8 billion.

These debts were taken out to avoid short-term budget cuts. But budget reductions may be necessary at this time, and may also be a refreshing change to Hawaii's trend of spending faster than the growth of the economy.

For example, between fiscal years 2010 and 2019, state general fund spending increased by a real average of 3.6%, versus 1.7% for the state's private sector, as measured by the state's gross domestic product.

Hawaii general fund versus Hawaii GDP growth, FY 2010-2019



Source: "GRIH calculations of state vs GDP growth," Grassroot Institute of Hawaii, "General Fund real," Feb. 10, 2021. Adjusted for inflation.

This imbalance is exactly the opposite of what is called for by the so-called golden rule of state budgeting: The private sector should grow faster than the government.[6]

One argument to keep government spending growth high during the current economic crisis is the "multiplier effect" of government spending, which is purported to generate $1.50 for every dollar spent by government.[7]

However, many economists dispute this claim and find that the economic gain of government spending may actually be negative when factoring in the harmful effects of public sector spending, such as taxation, government bureaucracy, heightened regulatory barriers for business, boondoggle mega-projects and the crowding out of private sector investment.[8]

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[6] Melissa Newsham, "Start working now to adopt a meaningful spending cap," Grassroot Institute of Hawaii, June 7, 2020. See also, Daniel J. Mitchell, "The Golden Rule of Spending Restraint," Cato Institute, April 7, 2014.
[7] Carl Bonham, et al., "Tap Fed Lending Facilities to Support Local Economy," The Economic Research Organization at the University of Hawaii, April 21, 2020; "HSTA, AFSCME, HGEA offer governor 15+ alternatives to public worker pay cuts," Hawaii State Teachers Association, HSTA.org, April 23, 2020; and letter to Gov. David Ige, from Randy Perriera, executive director of the Hawaii Government Employees Association, April 21, 2020.
[8] Joe Kent, Ken Schoolland, Per Bylund and Victor V. Claar, "'Multiplier effect' is poor justification for increased government spending," Grassroot Institute of Hawaii, May 9, 2020; Ken Schoolland, Harry Messenheimer and Gale Pooley, "Economic freedom is the real 'multiplier'," Honolulu Star-Advertiser, Dec. 15, 2020.

Suffice to say that there is economic debate about whether the “multiplier effect” of government spending produces economic gain, and that Hawaii’s record of public spending overtaking private sector growth has not resulted in a healthy economy.

Essentially, Hawaii’s state government is growing faster than can be healthfully sustained by the private sector. The private sector is the source of the state’s funding. If the private sector is growing slower than the government, that means private sector taxpayers are able to keep less of their earnings for themselves.

Adhering faithfully to the golden rule of state budgeting means there would be more money for Hawaii residents to invest in new businesses, buy new homes, afford college educations for their children and generally accumulate capital that is essential to a sustainable, healthy and prosperous economy.

A healthy and growing private sector also would organically generate the taxes the government needs to meet its responsibilities to the public, without the need for increased taxes or large amounts of unfunded liabilities.

The current reality is that Hawaii state spending has been outpacing private economic growth for at least a decade. Since fiscal 2012, lawmakers have exceeded the state’s constitutional spending cap by a total of $1.4 billion.[9] Bypassing the spending cap requires a two-thirds vote in both chambers of the Legislature, but all budget bills over the past decade have been approved nearly unanimously.

Hawaii general fund spending versus legal spending cap, 2010-2020, in millions

Fiscal Year	Spending limit (cap)	Total amount spent	Excessive Spending
2020	$8,168	$8,034	
2019	$8,012	$7,868	
2018	$7,905	$7,701	
2017	$7,090	$7,555	$465
2016	$6,668	$6,831	$163
2015	$6,446	$6,450	$4
2014	$5,894	$6,213	$319
2013	$5,596	$5,676	$80
2012	5,043	$5,474	$431

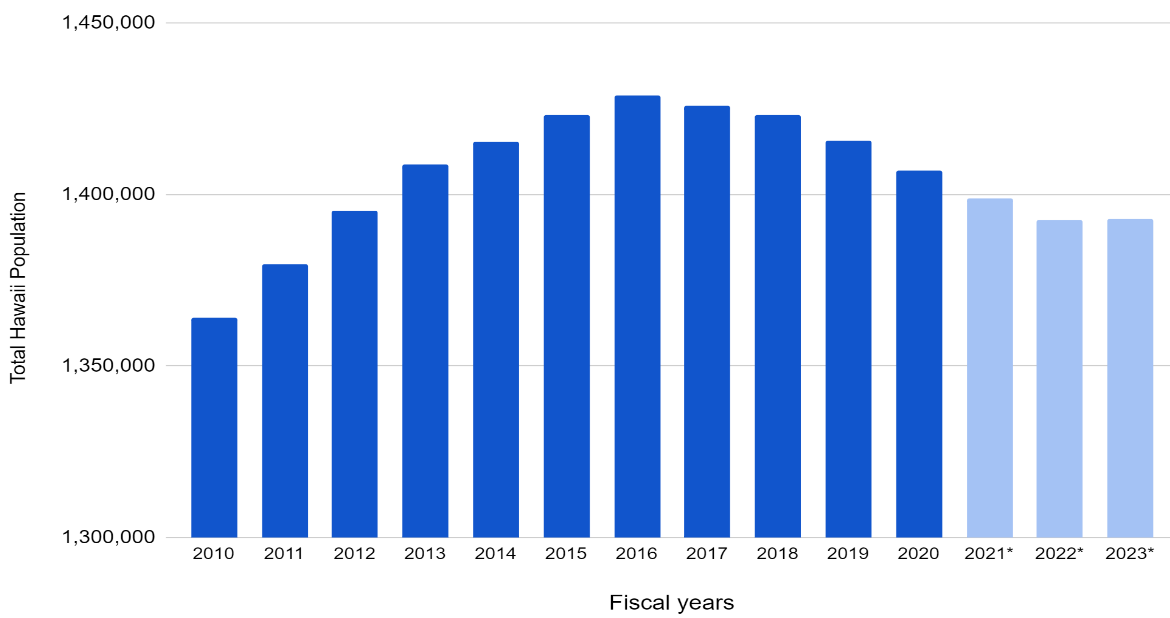
[9] “NEWS RELEASE: State deficit equals overspending since 2012,” Grassroot Institute of Hawaii, Dec. 16, 2020.

2011	5,394	$5,039	
2010	5,832	$5,208	
		Total excessive spending:	$1,462

Source: "NEWS RELEASE: State deficit equals overspending since 2012," Grassroot Institute of Hawaii, Dec. 16, 2020.

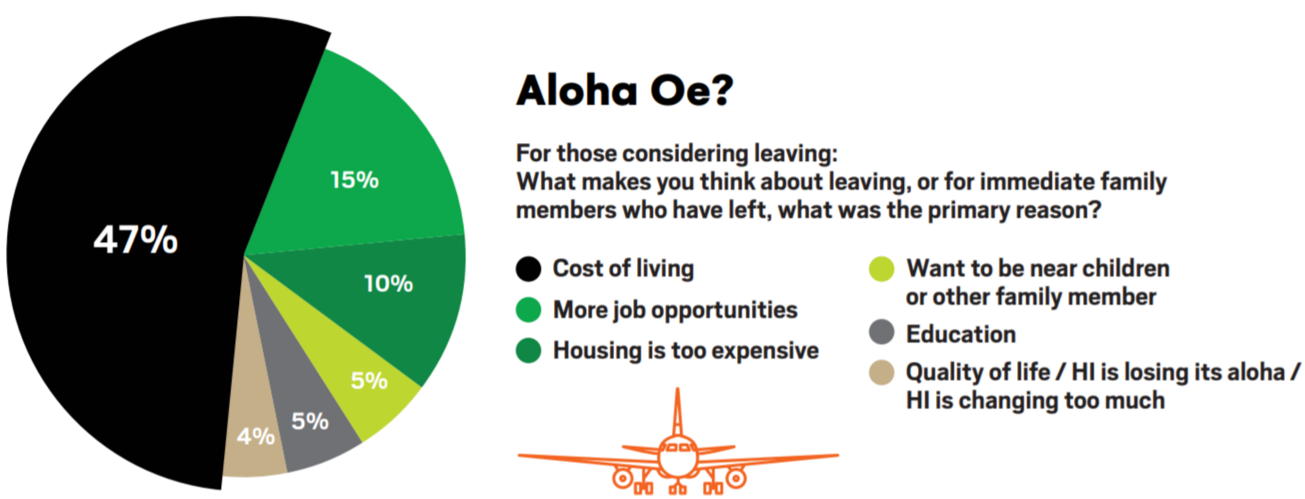
This excessive spending has been funded by taxes, which have been increased every year over the past decade.[10] This, in turn, has increased Hawaii's cost of living, which is one reason Hawaii has been suffering a net population loss in recent years. Since 2016, nearly 22,000 residents have moved to the mainland,[11] many of whom have cited Hawaii's high cost of living and lack of job opportunities as a primary factor.[12]

Hawaii population decline since fiscal 2016



"Annual Estimates of the Resident Population for the United States, Regions, States, and the District of Columbia: April 1, 2010 to July 1, 2020," U.S. Census Bureau, December 2020. Note: * Projected.

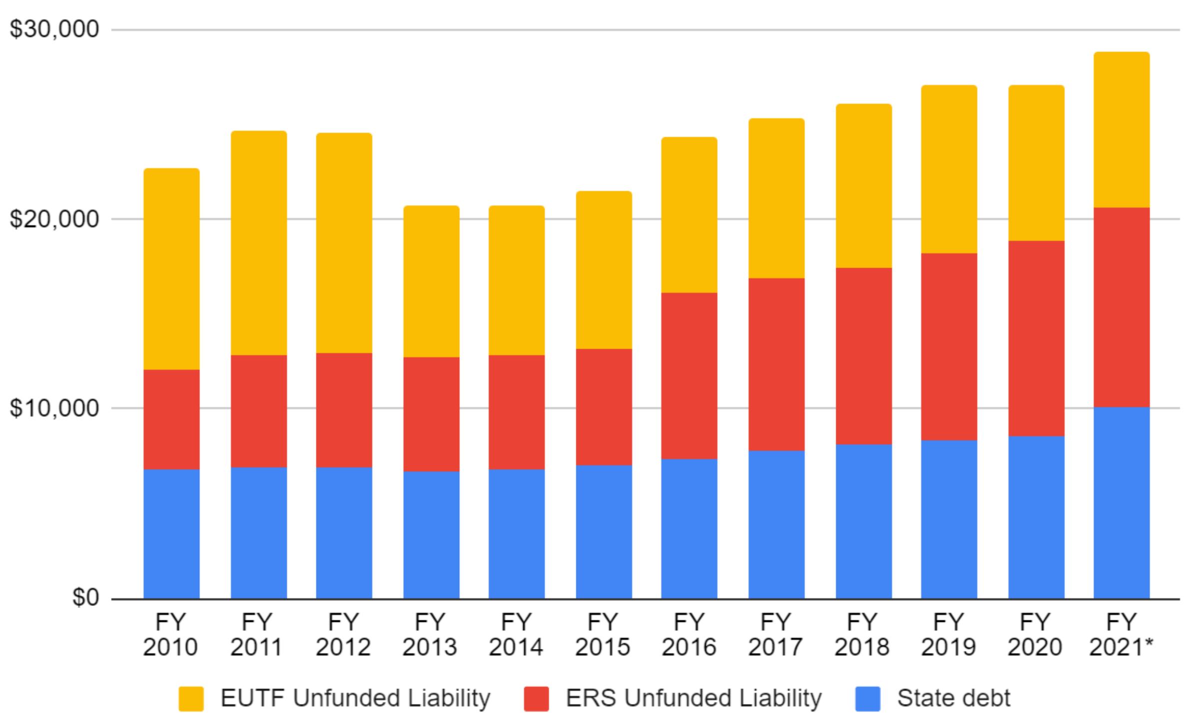
[10] "History of Hawaii tax increases 2010-2020," Grassroot Institute of Hawaii, March 3, 2021.
[11] "Annual Estimates of the Resident Population for the United States, Regions, States, and the District of Columbia: April 1, 2010 to July 1, 2020," U.S. Census Bureau, December 2020.
[12] "Hawaii Perspectives," Pacific Resource Partnership, Spring 2019, p.11



"[Hawaii Perspectives]()," Pacific Resource Partnership, Spring 2019, p.11.

Another measure of Hawaii's economic health — or its fragility, as the case may be — is the amount of its debt. Over the past decade, bond debt and unfunded liabilities for public pension and health benefits have increased to the point where Hawaii residents are now on the hook for nearly $28,000 per person.

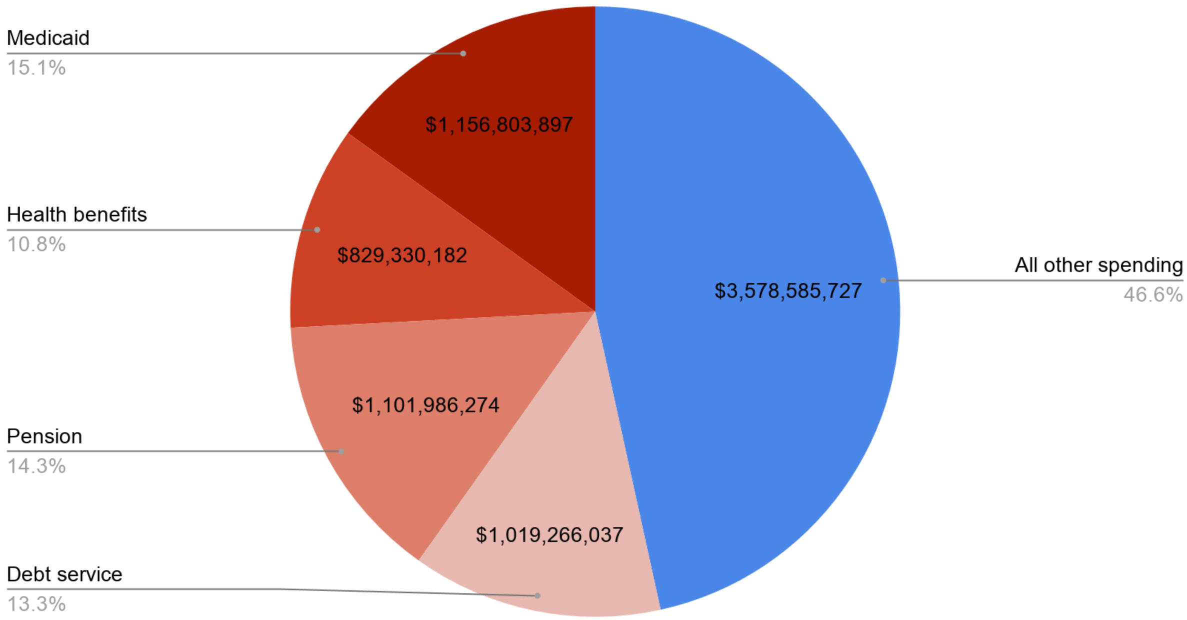
Hawaii unfunded liabilities and state debt per capita



*Source: "Total state debt" Grassroot Institute of Hawaii, Jan. 22, 2021. * Estimated debt as of Jan. 22, 2021.*

These debts and unfunded liabilities, along with Medicaid, now take up 56% of the state general fund, leaving an ever smaller portion to pay for all other state general fund costs.

Hawaii general fund, fiscal 2022



Source: "Hawaii State Executive Biennium Budget for fiscal years 2021 - 2023," Hawaii Department of Budget and Finance, p. 60.

As previously stated, this trend of additional spending, taxation and debt left Hawaii's economy weak even before the Great Lockdown Crash of 2020. As of fiscal 2019, before the COVID-19 crisis, Hawaii's gross domestic product was tanking at minus 0.5%, the lowest GDP rate in the nation.[13] In other words, the coronavirus crisis was the straw that broke the camel's back.

So here we are, at a crossroads

Considering the state's fiscal track record over the past decade and more, you might think advocates of more taxes and spending would be taking pause. Not so.

Incredibly, state lawmakers are considering a bill — SB56, "relating to revenue generation" — that would impose the highest marginal income tax rate in the nation for people making over $200,000.[14] Whether that measure passes or fails, it is an indication that lawmakers are still open to increasing taxes — in this case, drastically.

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[13] "SQGDP9 Real GDP by state," U.S. Bureau of Economic Analysis, Dec. 23, 2020.
[14] "SB56, Relating to Revenue Generation," Hawaii State Legislature, 31st Legislaure, 2021.

Will members of the House follow suit? Thankfully, that is looking like a dim possibility. And there are, after all, a lot of smaller tax bills that they might be able to push through without significant public pushback.

But in any case, the damage from SB56 to some extent has already been done.

Hello tax increase, goodbye doctors

In response to the Hawaii Senate approving the bill almost unanimously, 24-1, doctors, among others, have contacted the Grassroot Institute of Hawaii saying the bill could aggravate Hawaii's already severe doctor shortage.

Radiologist Dr. Scott Grosskreutz, of the Hawaii Physician Shortage Crisis Task Force, said many of the doctors he's talked with have said they are reevaluating whether they should relocate to the mainland. News of the bill, which made headlines across the country, also could discourage doctors from moving here in the first place.

"Doctors incur huge debts throughout college, medical school, internship, residency and fellowship training," Grosskreutz said. "When they finally are ready to start practice in their 30s, they often have little or no retirement savings and owe over $200,000 of student debt."[15]

Not only that, "In Hawaii, our practice start-up costs are often hundreds of thousands," Grosskreutz said. "The high overhead costs for offices and support staff, high income taxes and very low reimbursements make our state unattractive to most young doctors looking to start up practice."[16]

He said doctors in Hawaii are frustrated and disappointed because for four years they have been trying to obtain a state general excise tax exemption for medical services. They still haven't received it, and now they might be facing a large personal income tax increase instead.

Dr. Kyle Varner, a former resident physician at Tripler Army Medical Center in Honolulu, who left Hawaii in 2016, stated, "I moved away because I want to get ahead financially, and I want to be financially independent. That's just not possible in Hawaii, even for somebody with my earning potential."

He said that after leaving Hawaii, he gained a "$50,000 a year increased salary."[17]

"The sunshine and the aloha is nice, but it's not worth the price," said Varner, who now lives in Washington state, which has no income tax.[18]

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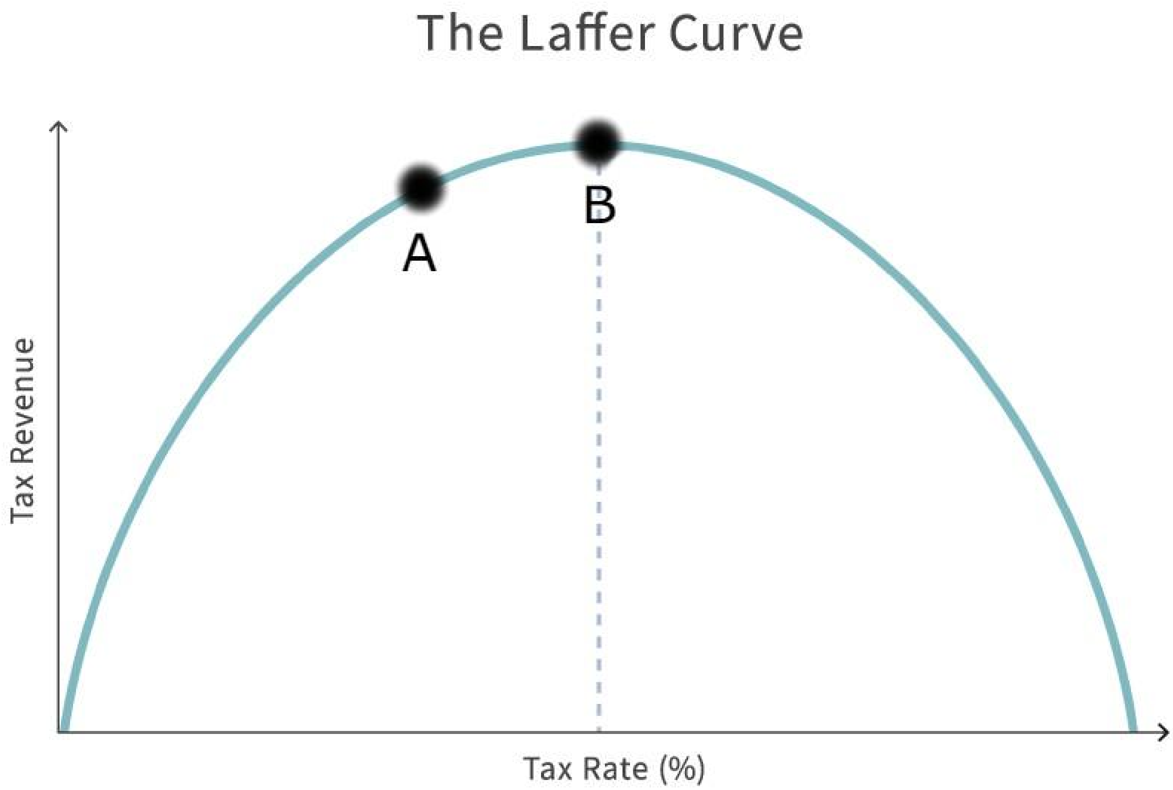
[15] Personal correspondence with Dr. Scott Grosskreutz, March 15, 2021.
[16] Ibid.
[17] Personal correspondence with Kyle Varner, March 11, 2021.
[18] "Income tax," Washington State Department of Revenue, Nov. 14, 2018.

Remember the Laffer Curve?

Taxation in Hawaii has likely reached the point where increases in tax rates will cause more harm than good. This can be illustrated on the "Laffer Curve," named after economist Art Laffer, which represents how much tax revenue can be generated by a government at various tax rates.



If Hawaii's level of taxation is represented by point B on the Laffer Curve above, then increasing tax rates will result in less revenue, since people will respond by either leaving the state, avoiding taxation or stopping productive work.

If on the other hand, Hawaii's level of taxation is represented by point A, then an increase in taxation would indeed result in more tax revenues, but the revenues would be minimal since people would be changing their behavior, such as by shutting down or leaving the state. In this scenario, the government would be imposing a lot of economic damage to get very little additional revenue.

Hawaii policymakers should assess where they think Hawaii is on the Laffer Curve, and respond accordingly.

How tax credits could help provide public services, inspire productivity

Not all public services need be funded through taxes. Another way to increase spending for the "public good" would be for the state to increase tax credits for charitable donations to Hawaii nonprofit organizations..

For example, all charitable donations in Hawaii after a taxpayer has paid over $100,000 in state income tax could be eligible for a tax credit or considered deductible.

Such a policy would help individuals direct money to those charitable causes he or she cares about, rather than have the money be spent on questionable causes by the state.

The productivity gains from such a policy are best illustrated by the following chart popularized by Milton Friedman.

The four ways money can be spent

Buying something...	using your own money	using someone else's money
for yourself	1 High concern for quality and cost.	2 High concern for quality, low concern for cost
for someone else	3 Low concern for quality, high concern for cost	4 Low concern for quality, low concern for cost.

Source: "Milton Friedman - The Four Ways to Spend Money," Free To Choose Network, YouTube video, July 31, 2012.

When people spend money themselves, they typically do it with a high concern for quality and cost. When they are spending someone else's money, the money is generally spent with a low concern for quality and cost.

A policy that incentivizes money to be spent on charity rather than on government programs could see the money better economized, since it would at the very least be done with a high concern for cost, as in quadrant three.

This could result in millions of dollars from Hawaii's wealthiest going to local charities, and perhaps even inspire more productive economic activity, since the policy would incentivize those with higher incomes to move to the state.

In sum: No new taxes

There is precedent for the Hawaii Tax Review Commission to recommend lowering state taxes. It happened in 1989,[19] and it could happen again now.

At the very least, the commission should consider recommending no change in tax rates, since tax stability is also desirable for entrepreneurs trying to plan for the future. Recommending "no new taxes" would send a message to our legislators that the Council wants them to keep their spending under control and at levels that Hawaii taxpayers can afford.

Freezing taxes or providing tax breaks may be just what Hawaii needs to boost its economy, incentivize entrepreneurial activity, keep doctors in the state, inspire charitable donations and pressure state lawmakers to get their spending in order.

It also will give the private sector time to start growing faster than the state government, which is key to putting Hawaii back on the road to opportunity and prosperity.

Thank you for the opportunity to submit our comments.

Sincerely,

Joe Kent
Executive Vice President
Grassroot Institute of Hawaii

[19] "Report of the Tax Review Commission," Hawaii Department of Taxation, Dec. 1, 1989.