

# Tax Expenditures in Paradise

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# Tax Expenditure: Definition

- A tax expenditure is a tax break, usually an exemption, deduction or credit, granted to selected taxpayers or for selected activities. In this presentation, I will restrict my attention to tax expenditures in Hawaii's General Excise Tax (GET).

# The Structure of Hawaii's (GET)

- The GET is a tax on gross business receipts.
- The main difference between the GET and a retail sales tax is that the GET pyramids on itself, because it is applied to sales by one business to another.
- The GET is imposed at the rate of 4% on retail sales and at the rate of 1/2% on wholesale sales.
- The GET on Hawaii businesses is complemented by the Use Tax on imports from unlicensed sellers.

# Identifying Tax Breaks in the GET

- The first task is to decide what should be in the GET base.
- The GET (Use Tax) is imposed on imports, whereas exports are exempt, so it appears to be meant as a tax on consumption rather than on production. Accordingly, I deem any exception from a uniform tax on all consumption by residents to be a tax expenditure. By residents, I mean legal residents, not those in Hawaii for a temporary purpose, such as tourists or those in the military.
- The ultimate goal is to get a tax structure that maximizes economic welfare of residents.
- I assume that meeting this goal requires that all consumption be taxed at a uniform rate. (I ignore optimum tax results that inelastically demanded goods or goods that complement untaxed leisure should be taxed more highly. I do this on grounds of practical application.)

# Why Limit the GET to Consumption of Residents?

- Why not tax sales to nonresidents?
- Suppose residents face perfectly elastic supply curves when they buy from a nonresident, and perfectly elastic demand curves when they sell to a nonresident. (This is the small country assumption in international trade theory.) Then the burden of the tax is borne entirely by residents and taxing both sales to nonresidents and purchases from nonresidents results in double taxation of some consumption by residents.
- We will consider later what happens if we relax our "small country" assumption.

# GET Exemptions for Business-to-Business Sales

- Since consumption is the ultimate purpose of business activity, taxes on business-to-business sales causes tax pyramiding.
- Most business-to-business sales are subject to GET at the wholesale rate. Whether an exemption from this rate is a tax expenditure by our definition depends on whether it brings greater uniformity to the taxes on all consumption. In any case, such taxes distort prices faced by businesses and encourage vertical integration.
- Examples of exemptions for business-to-business transactions include the deductions allowed for sales of one contractor to another, the income splitting allowed for certain commission income, and the deduction of certain payments from a hotel owner to the hotel operator.
- Since I can't determine which exemptions for business-to-business sales might make the tax on consumption more uniform, I treat them all as "potential" tax expenditures, to be measured against the wholesale rate of tax (1/2%).

# The GET Exemptions for Exports and Sales to the Federal Government

- By definition, these items are not part of consumption by residents, so exempting them does not give rise to a tax expenditure, but should they be taxed to meet our ultimate goal?
- If the tax is borne by the customer, it does not result in double taxation of consumption of residents, but instead allows residents to export part of their tax burden.
- Though not tax expenditures, these exemptions might represent missed opportunities to export part of our tax burden to nonresidents.

# The Wisdom Embodied in the GET

- Consider the following GET exemptions:
- Sales to the federal government. The exemption is available only for sales of tangible personal property and only if the sale is not tied to a service. For example, sale of a carpet to the federal government would be exempt, but if the seller installs the carpet, the entire sale is taxable, including the price of the carpet as well as the cost of installation.
- Sales to tourists (Hawaii's biggest export) are taxable, whereas sales to out-of-state customers are exempt.
- Some sales to tourists are taxed more highly than consumption of residents. For example, the transient accommodations tax and the rental vehicle surcharge.
- The above sales probably face less elastic demands than sales to out-of-state customers and so present a better opportunity to export the tax.

# More on the Wisdom Embodied in the GET

- Much of the easily eliminated tax pyramiding in the GET has been accomplished.
- The capital goods excise tax credit rebates the GET on capital equipment purchased by business.
- Goods and services that are clearly to be resold get the wholesale rate.
- Much of the remaining tax on business-to-business sales is necessary on administrative grounds – to prevent people from disguising consumption as a business input.
- The tax on wholesale sales accounts for only 5% of total GET receipts. Furthermore, estimates place the average effective rate of GET on all taxable consumption at only 4.5%, so pyramiding is small.

# The Biggest Tax Expenditures are the Exemptions for Nonprofits

- The clearest tax expenditures are those for nonprofit organizations. These are also the biggest tax expenditures and account for 47% of the clear tax expenditures.
- Many nonprofit activities reduce the need for government services and so are properly not taxed.

# Overall Importance of Tax Expenditures in the GET

- I estimated that the total of GET tax expenditures, including possible tax expenditures at the wholesale rate, was only \$387.5 million in fiscal year 2011. This is less than 16% of the total GET collections that year.

COMMENTS WELCOMED