CHAPTER 16

EXCISE TAXES

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"Is it true that Hawaii would need a 20 percent sales tax to generate the same revenue it gets from a 4 percent excise tax?"

A Hawaii State Tax Review Commission reached that conclusion in the mid-1980s. I think 16 percent is closer, but even that would seem shockingly high to most people.

Technically, both sales and excise taxes are on transactions. However, it's best to think of them as taxes on consumption. Experts generally agree that a well-designed system will tax income, wealth and consumption on a roughly equal basis, that is, one-third of total revenues from each source. The basic idea is to spread the pain, and to keep rates as low as possible.

Hawaii residents pay unusually high taxes on income and consumption, and unusually low taxes on wealth. The most distinguishing characteristic of Hawaii's system, however, is the potency of its excise tax. Comparing a conventional sales tax to Hawaii's excise tax is a bit like comparing a firecracker to a hand grenade.

We apply the 4 percent excise tax rate to an amazingly broad base. The implications of this are interesting. For example, in most states the sales tax rate is higher than 4 percent. But the resulting revenue, as a percentage of statewide personal income, averages only 2.3 percent nationally. In only two mainland states does this percentage exceed 4 percent. Hawaii's recently was 5.8 percent!

Revenues per person tell the same story. Hawaii's $1,057 per person is much greater than the per-capita sales tax revenue collected by any other state, including states that like Hawaii shift a sizable portion of total taxes to nonresidents.

The phenomenal productivity of our excise tax has resulted in a dependence on it as a revenue source. The excise tax contributed 50.4 percent of Hawaii's total tax revenues in 1990. On the average, other states get 33.1 percent of their revenues from their sales tax.

Tax all transactions. The excise "tax base," used in measuring the potency of the tax, is calculated by dividing the amount collected by the tax rate. Many mainland experts would consider enactment of a sales tax with a base in excess of 100 percent of statewide personal income to be political suicide. Yet Hawaii's excise tax base is 144.1 percent of personal income—three times the average state's 46.3 percent.

Some of this is attributable to Hawaii's ability to tax tourists and other nonresidents, but most of the difference comes from Hawaii's decision to tax virtually every transaction occurring within the state. Considerable diversity exists, but other states usually exempt sales by certain entities, manufacturers, service providers and wholesalers—all of which are taxable under Hawaii's system. Hawaii does exempt a few entities, including banks and hospitals, but the list is narrow. Also, mainland states often exempt such transactions as the sale of food or payments for property leases, both of which are taxed in Hawaii.

Hawaii's unusually broad tax base has several strong advantages. First, it permits Hawaii to raise more revenue than other states while using a relatively modest tax rate. Low rates are normally preferred because they are less likely to cause people or businesses to change their behavior to avoid the tax or evade payment. Plus, it looks good politically. Second, the broad base is more likely to result in horizontal equity, which means that people with the same level of consumption pay the same tax. In many states, sales tax liability depends as much on what you consume as on how much you consume.

Shortcomings. Hawaii's excise tax is not perfect. The relationship between a household's income and its tax payments is normally referred to as vertical equity. In this regard the excise tax is regressive; as household income rises, tax payments fall as a percentage of that income. The most important reason is that households are able to save more as they earn higher incomes.

Many in Hawaii believe that a progressive income tax (one in which tax payments as a percentage of household income rise, as income rises) is important for offsetting the regressivity of the excise tax. This is the primary justification for the excise-tax credit available to Hawaii residents when they file state income tax returns.

It's OK for one component of a state's tax system to be regressive as long as other components offset that to a significant degree. When Hawaii's progressive income tax is combined with its regressive excise tax, the overall tax burden is only mildly regressive. Hawaii's tax system is quite progressive compared to those of other states (in other words most states have a tax system that is significantly more regressive than Hawaii's).

Pyramiding. Another shortcoming of Hawaii's excise tax is the potential for pyramiding because the tax is imposed at each stage of the production process. The total tax rate incorporated in the final price is greater than the legislated rate. For example, suppose a parcel of property is leased for $1,000 and subsequently subleased two times each after a 10 percent markup. This is not uncommon in Hawaii. The total excise tax on leasing this property would be more than 14 percent of the initial lease rent. A tenant next door could be paying a mere 4 percent. That seems unfair.

Pyramiding can be a problem for a variety of other reasons. First, it encourages tax evasion. In the leasing example, there is an incentive to hide the subleases. A general rule is that tax evasion rises with the effective tax rate. Second, people will tend to buy fewer goods and services where the tax pyramids most. People may be worse off when their consumption choices are altered, and heavily taxed businesses are at a competitive disadvantage. Third, pyramiding can change the way businesses operate. A manufacturer typically would be taxed upon selling a product to a wholesaler, who is then taxed upon selling it to the retailer, who is then taxed as the product finally is sold to the consumer. These three levels of tax can be reduced to one if the manufacturer buys the wholesaler and the retailer, and thereafter sells directly to the consumer. Thus, a pyramiding tax tends to work to the disadvantage of small or new businesses.

For the most part, however, pyramiding is less onerous than might be expected. One study found that the effective tax rate on average consumption expenditures in Hawaii was "only" 5.3 percent. The main reason it wasn't higher is that sales by manufacturers and wholesalers are taxed at 0.5 percent, unless the sale is considered to be at retail, so usually the pyramiding is of a 0.5 percent tax. Also, our economy may be less complex than that of other states in that goods and services go through fewer stages of production (although a less complex economy partly could be the product of efforts to avoid the tax). In any event, fewer stages of production mean less pyramiding.

Politicians love it. Politicians love the excise tax (once it is in place) because it raises so much revenue without ruffling too many feathers. First of all, most voters who compare mainland sales tax rates to Hawaii's 4 percent excise tax feel pretty good about it. You now know that is like comparing apples to a watermelon. Second, unlike property taxes that get paid in two big installments each year (ouch, that hurts) or income taxes that get added up on an annual return (wow, I can't believe I pay that much), consumers seldom pay a large excise tax at one time and almost never add up the total for the year. How much in excise taxes did you pay last year? See what I mean?

Mainland politicians covet Hawaii's excise tax. Slowly but surely, virtually every state with a sales tax is considering adjustments to make it more like our excise tax. Well-financed groups lobby loudly against such changes and thus far have been more successful than not. For example, 1987 Florida legislation put a wide range of services under its sales tax, but lobbying pressure led to repeal after only six months. Florida is again considering taxation of services, but this time more narrowly selected. Most other states also want to tax a broader set of goods and services, but thus far they have experienced only piecemeal success.

Hawaii politicians especially like the fact that nonresidents pay roughly 30 percent of total excise taxes. It's called tax exporting. Interestingly, the few studies that have been done on tax exporting in

Hawaii indicate that our property tax is an even more effective vehicle.

I have commented on the regressivity of our excise tax, the fact that it pyramids, that it is largely a hidden tax, and that it's not necessarily best for tax exporting. Does that mean I think radical changes are in order? It may surprise you to find that I do not. Even with its flaws, Hawaii's excise tax is a good tax, in need of nothing more than fine tuning and, perhaps, a rate reduction. It ain't perfect, but it ain't broke either. In a world where all taxes are flawed in one way or another, as long as the rate is kept as low as possible, Hawaii's excise tax looks pretty good to me.

I can't believe I paid the whole thing

Despite its relatively low rate, Hawaii's potent excise tax generates more tax revenue, per person, than do similar taxes in other states.

Source: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1991, Volume II: Revenues and Expenditures*, M-176-II, Washington, D.C., October 1991, p. 248.

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