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The Exorbitant Cost of Collecting Honolulu's Rail Surcharge Tax

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Act 247, SLH 2005, granted counties the authority to impose a county surcharge of no more than 0.5% on gross income that is subject to the State's GET [General Excise Tax] at the rate of 4.0% to fund county public transportation systems. The Act specified that the surcharge be levied no earlier than January 1, 2007 and that it be automatically repealed on December 31, 2022. The Department of Taxation is required to administer and collect the surcharge for the counties. The City and County of Honolulu was the only county to adopt the surcharge, which took effect on January 1, 2007. The State keeps 10.0% of the collections from the county surcharge as administrative costs, and Honolulu County receives the remaining 90.0% of the collections.

(SOURCE: DEPARTMENT OF TAXATION, STATE OF HAWAII, *ANNUAL REPORT 2015-16*)

It is not unusual for local governments in the U.S. to levy their own sales taxes within restrictions imposed by state law. In 1962 only 12 states authorized their local governments to levy their own general sales tax; by 2015 the number of states had climbed to 38. In 2014, there were approximately 10,000 local governments in the U.S. that imposed a general sales tax, and in most states their sales taxes were administered by their state governments.[1]

In Hawaii, Act 247, SLH 2005 became law on July 12, 2005 without Governor Linda Lingle's signature. Between January 1, 2007 and the end of fiscal year 2016 (ending on June 30), the State has reaped a cumulative total of $195 million from the 10% administrative fee. The money went into the State's General Fund which pays the day to day bills of running the State government. The City and County of Honolulu's share of the .5% county surcharge tax came to $1.75 billion. Delays and massive cost over-runs in the construction of the rail system (HART) forced the County to go back to the Legislature (2015) to seek authorization to extend the surcharge tax beyond December 21, 2022 to December 31, 2027.[2] The request was approved with the condition that revenues must be used only to pay for "capital costs" (HB134 CD1). Honolulu County officials are back at the 2017 Legislature to seek authorization for another extension of the county surcharge tax, this time in perpetuity.[3] Without the extension, the 20-mile rail project cannot be completed to Ala Moana Center, its intended final destination.

The rail project's growing funding shortfall has raised questions about the size of the fee (10%) charged by the State to collect the county surcharge tax. Act 247 states, "…the director of finance shall deduct ten per cent of the gross proceeds of a respective county's surcharge on state tax to reimburse the State for the costs of assessment, collection, and disposition of the county surcharge on state tax incurred by the State." These costs "…shall include any and all costs, direct or indirect…" The law suggests that costs should reflect average costs rather than marginal (incremental) costs.[4]

[1]Institute for Professionals in Taxation, *Locally Administered Sales and Use Taxes*, 2016; also Tax Foundation, *State and Local Sales Tax Rates in 2015*, April 8, 2015.

[2]It has drawn national attention. *New York Times*, "Hawaii Struggles to Keep Rail Project From Becoming a Boondogle," March 20, 2016.

[3]*Honolulu Star Advertiser*, "Legislators grill city on need for rail tax extension," January 25, 2017.

[4]Professor Mikesell of Indiana University notes that local governments in the U.S. usually interpret costs as marginal costs while states tend to interpret them as average costs. John L. Mikesell, *International Experiences with Administration of Local Taxes: A Review of Practices and Issues*, World Bank, 2003.

Does the State Department of Taxation (DOTAX) need all the revenues from the 10% fee to administer the county surcharge tax? Definitely not! In a lawsuit filed by the Tax Foundation of Hawaii against the State of Hawaii to compel the State to refund excess fees to the County, the Foundation showed that revenues from the 10% fee currently exceed the entire budget of the tax department. The following table (Table 1) shows the distribution of county surcharge tax revenues and annual DOTAX total operating expenditures between FY 2006 and FY 2016.

Table 1 shows that beginning in FY2011, and every year thereafter, the State's 10% share of the county surcharge tax revenues exceeded the annual operating expenditures of DOTAX. Table 2 shows (1) annual county surcharge tax revenues as a percentage of total State tax collections; and (2) revenues from the 10% administrative fee as a percentage of annual DOTAX operating expenditures.

TABLE 1 : DISTRIBUTION OF HONOLULU COUNTY SURCHARGE TAX REVENUES AND TAX DEPARTMENT ANNUAL OPERATING EXPENDITURES: FY 2006-FY2016 (IN $MILLIONS)

Year	Total	To Hon. County	To State DOTAX	Operating Expenditures
2016	$259.0	$233.1	$25.9	$24.0
2015	248.6	223.7	24.9	20.7
2014	242.7	218.4	24.3	20.9
2013	193.1	173.8	19.3	18.0
2012	211.9	190.7	21.2	18.1
2011	199.0	179.1	19.9	18.3
2010	175.1	157.6	17.5	19.7
2009	178.8	160.9	17.9	25.5
2008	187.9	169.1	18.8	25.2
2007	53.8	48.4	5.4	27.2
2006	0	0	0	21.7

SOURCE: TAX FOUNDATION OF HAWAII VS STATE OF HAWAII, CIVIL NO. 15-1-2020-10 ECN, EXHIBIT G, FEBRUARY 24, 2016; DEPARTMENT OF TAXATION, STATE OF HAWAII, *ANNUAL REPORT 2015-2016*, AND EARLIER YEARS.

Table 2 shows that since its implementation, Honolulu's rail surcharge tax revenues have consistently comprised less than 4% of total DOTAX tax collections each year, while the administrative fee has consistently exceeded 100% of DOTAX's annual operating expenditures since FY2011. According to DOTAX's 2015-16 Annual Report, in FY2016 "…The Department's operating expenses were $24 million…The Department collected $6.89 billion in taxes in FY2016, so the cost of collecting each 100 dollars of taxes was about 35 cents." In other words, the cost of running the entire tax department was equal to 0.35 percent of total tax revenues collected. Table 3 shows the average cost to collect $100 of taxes between FY2003 and FY2016.

TABLE 2: TOTAL SURCHARGE REVENUES* AS % OF TOTAL STATE TAX COLLECTIONS VS. ADMINISTRATIVE FEES AS % OF TOTAL DOTAX OPERATING EXPENDITURES: FY2007-FY2016

Year	Surcharge Revenues as % of Total Tax Collections	Administrative Fee Revenues as % of DOTAX Operating Expenditures
2016	3.8%	107.9%
2015	3.8	120.0
2014	3.7	116.3
2013	3.0	107.2
2012	3.5	117.1
2011	3.8	108.7
2010	3.4	88.8
2009	3.6	70.1
2008	3.4	73.7
2007	1.0	19.9

SOURCE: DOTAX, VARIOUS *ANNUAL REPORTS*.
NOTE: * SURCHARGE REVENUES INCLUDE 10% ADMINISTRATIVE FEE.

TABLE 3: AVERAGE COST TO DOTAX TO COLLECT $100 OF TAXES: FY2003-FY2016 (IN CENTS)

Year	Cost/100	in %
2016	35 cents	0.35%
2015	32	0.32
2014	33	0.33
2013	29	0.29
2012	30	0.30
2011	35	0.35
2010	38	0.38
2009	52	0.52
2008	47	0.47
2007	51	0.51
2006	43	0.43
2005	40	0.40
2004	45	0.45
2003	49	0.49

SOURCE: DOTAX, *ANNUAL REPORT*, VARIOUS YEARS.

Before the surcharge tax was implemented beginning on January 1, 2007, tax collection costs were between four-tenth (0.4%) and one-half of 1 percent (0.5%) of total tax collections (2003-2006). After the tax was implemented, collection costs have fallen to between three-tenths (0.3%) and four-tenths of 1 percent (0.4%) of total tax collections, except during the Great Recession (2007-2009). Decline in tax collections during the Great Recession raised the collection cost ratio.

In written testimony on H.B. No. 1309 H.D. 2 on March 21, 2005 presented before the Senate Committee on Transportation & Government Operations and Senate Committee on Intergovernmental Affairs, State Director of Taxation, Kurt Kawafuchi, testified against requiring the Tax Department to levy, assess, collect and otherwise administer a county surcharge tax because… "it will seriously detract from its own efforts to maximize State collections and will utilize Department resources to enforce the county tax…" He opined that the Department needs to "produce new forms, reprogram the computers to accept additional data entries, train staff and educate the public about the taxes." He concluded by saying, "In order to administer the tax, the Department estimates that it will require a one time appropriation of $3.6 million for hardware, software, and equipment and $2.5 million annually thereafter for recurring staffing and operational costs."[5] These cost estimates assume that all four counties might adopt a surcharge on the GET to fund local transportation projects.

Kawafuji further testified that a 1% surcharge on GET and use tax would provide additional $296 million tax revenues for Honolulu County.[6] Thus, a one-half percent county surcharge--as eventually enacted by City and County of Honolulu Ordinance No. 05-027--should generate $148 million in tax revenues. Kawafuji's estimated $2.5 million "for recurring staffing and operational costs" represents only 1.7% (=$2.5 million/$148 million x 100) of the $148 million additional tax revenues expected to be generated by the surcharge. Since State lawmakers had this information before Act 247 became law in July, 2005, it is rather curious how the 10% figure slipped into the final county surcharge tax bill. Applying the $2.5 million to actual surcharge tax collections between FY2008 and FY2016, collection costs would represent between 1 and 1.4% of surcharge tax revenues.

To help with the transition, the Legislature made an emergency appropriation of over $5 million for FY2007 to reimburse the Department for costs incurred in implementing and administering the county surcharge tax. Act 045 was signed into law by Governor Linda Lingle on April 27, 2007. Act 213, SLH 2007 gave the Department of Taxation 19 permanent positions and 4 temporary positions for FY2008, and 19 permanent positions and 1 temporary position for FY2009 "to support the collection of County Surcharge tax and to help alleviate the additional workload caused by the County Surcharge tax to the rest of the Department." The total amount budgeted was $749,876 for FY2008 and $700,508 for FY2009. In FY2007, the State's 10% share of the county surcharge tax generated $5.4 million for the State's General Fund, about the same amount appropriated to the Tax Department under Act 045 to fund start-up expenses. In FY2008 and FY2009, the State's 10% administrative fee generated $18.8 million and $17.9 million, respectively.

The administration of the new county surcharge tax apparently went well. The Department's Annual Report As Required By Act 213, SLH 2007, Section 121 for the Period July 1, 2007 Through June 30, 2008 concluded that "The Administration of the County Surcharge tax has been relatively smooth to the Department's knowledge." In other words, the county surcharge tax is not difficult to administer.

[5] Reproduced in Tax Foundation of Hawaii vs. State of Hawaii, February 24, 2016, Exhibit A. This bill would take effect on July 1, 2010 and is repealed on June 30, 2015.

[6] The other three counties would receive a combined $122 million.

Nonetheless, the Tax Department has not conducted a thorough study of what it actually costs to administer the county surcharge tax.[7] Since FY2011, it cost less than 35 cents for the Tax Department to collect $100 of total State taxes. The county surcharge tax's prorated share of total tax collection costs—by applying an average cost of .35 per $100 of surcharge tax revenues—would amount to less than 1 million each year. House Speaker Joe Souki recently indicated that he supports reducing the 10% administrative fee to 5%.[8] That is still too high. Senate Ways and Means chairwoman, Jill Tokuda has suggested that lawmakers might consider eliminating the 10% administrative fee altogether to help the City complete the rail project.[9]

A recent study prepared for the Institute for Professionals in Taxation surveyed 10 states where the state tax agency administers local sales taxes on behalf of their local governments to ascertain the fees assessed for state tax administration.[10] Arizona, Illinois and Kansas don't impose any fee. Colorado imposes no fee for counties and statutory cities, but requires a fee for special districts. In states where a fee is assessed, they are approximately 1% of tax revenues remitted (i.e. Washington State, Tennessee and West Virginia). The range is from 0.5% in Oklahoma to 3% maximum in Florida. In North Carolina, the fee is set to state costs, which may vary month to month. An earlier study examined the charges in 30 states for administration of local sales taxes (if any) and found 11 states charged a fee based on the cost of administration but "almost always less than 1 percent of collections."[11] Six had no charges, and the remaining states charged statutory percentages.

Hawaii's State Government has unnecessarily profited from the Honolulu rail project. It is time for State lawmakers to rethink the 10% administrative fee. Right now, it is exorbitant. A more reasonable fee is between 0.5% and 1.0%.

[7] Tax Foundation of Hawaii vs. State of Hawaii, Exhibit A.

[8] *Honolulu Star Advertiser*, "House speaker wants city to help fund rail," January 13, 2017.

[9] *Honolulu Star Advertiser*, "Legislators grill city on need for rail tax extension," January 25, 2017. The latest estimates indicate the rail project costs have ballooned from less than $5 billion initially to $10 billion. The Federal Transportation Administration is expected to provide $1.55 billion of the total. Eliminating the administrative fee alone won't be enough to eliminate the projected funding short-fall of about $3 billion.

[10] Institute for Professionals in Taxation, *Locally Administered Sales and Use Taxes*, 2016, Part III.

[11] John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, 1994.

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