# Tax Incentives in Tourism: Hawaii's Hotel Remodeling and Construction Tax Credits

by

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**Tax Incentives in Tourism:**
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Fiscal incentives are widely used by governments around the world to attract private investment in "preferred" industries, including tourism.[1] Incentives are often granted to offset actual or perceived differences in the cost of doing business in different political jurisdictions whether the cost differences arise from tax differences or from differences in transportation, labor, or other costs.[2] Incentives raise the return to capital thereby making investment in a location more attractive. Several types of fiscal incentives exist. They include government provision of below market interest loans, tax relief through the use of credits, deductions, or abatements, direct grants of land and facilities, and taxpayer financed work force training for targeted firms and industries. In the U.S. tax incentives

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*We are indebted to Paul Brewbaker, Chris Grandy and Marcia Sakai for helpful comments on earlier versions of this paper.

[1] See, for example, Howell H. Zee, Janet G. Stotsky, and Eduardo Ley. *Tax Incentives for Business Investment: a Primer for Policy Makers in Developing Countries* (Washington D.C.: International Monetary Fund, 2002); National Association of State Development Agencies. *Directory of Incentives for Business Investment in the United States: A State by State Guide, 2002 edition* (Aspen: Aspen Publishers Inc., 2002); David Brunori, *State Tax Policy* (Washington D.C.: Urban Institute Press, 2001); and Stephen R. C. Wanhill, "Evaluating the Worth of Investment Incentives for Tourism Development," *Journal of Travel Research*, vol. 33, no. 2 (Fall, 1994), pp. 33-39.

have become "the weapon of choice" among states in the battle for business investment.[3] Whether tax incentives are cost-effective in inducing the desired investment remains "highly inconclusive".[4]

Critics of tax incentives argue that they (1) reduce the tax base and result in less revenues for government programs; (2) distort resource allocation by favoring some activities over others; and (3) encourage corruption.[5] Incentives given on a case-by-case basis can also unfairly favor some businesses over others in the same line of business. When asked whether governments should ever subsidize private investment in tourism, University of Toronto economist, Richard Bird, responded that "The correct answer is almost certainly 'no'. If private investors are not willing to risk their own funds in the tourist business, it is not clear why public money should remove the risk and leave them the profit."[6] Proponents of tax incentives argue that in the absence of such incentives some projects that may yield substantial spillover benefits to the community might not be built.[7] Indeed, strategically applied tax incentives can correct market failure by inducing investors to make the desired investment and enhance an economy's overall efficiency—i.e. allow an economy to attain its potential output.

Beginning in 1997, the Hawaii State Legislature passed several tax credit bills to stimulate hotel remodeling and construction in Hawaii (hereafter referred to as "hotel tax credits"). In this paper, we examine the effects of these tax credits on hotel capital (i.e.

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[2] Ronald C. Fisher. *State and Local Public Finance* (Chicago: Irwin, 1996), p. 619.
[3] Brunori (2001).
[4] Zee et. al. (2002), p.1.
[5] Ibid., pp. 2-3.
[6] Richard M. Bird, "Taxing Tourism in Developing Countries," *World Development*, vol. 20., no. 8 (1992), p. 1155.
[7] Wanhill (1994) and Zee et. al. (2002).

construction) spending and the performance of the lodging industry in Hawaii. Given the brief history and duration of these tax credits, our conclusions are admittedly based on sparse data. While we make no claim that this paper is a rigorous cost-benefit analysis of the hotel tax credits, nonetheless, the observations provide useful insights about the merits of employing such credits as an economic stimulus and/or redevelopment strategy.

**Chronology of Hawaii's Hotel Tax Credits**

The history of Hawaii's hotel credits is summarized in the Hawaii Department of Taxation's *Annual Tax Credit Report to the Governor*[8]. The hotel tax credit history began in 1997 when the Legislature passed Act 108 which provided a *refundable* income tax credit of up to 4% of renovation cost for each qualified hotel facility located in Hawaii, with the amount of the income tax credit capped at 10% of the transient accommodation tax (TAT)—commonly referred to as the "hotel room tax"-- remitted by the taxpayer in the preceding year.[9] Act 108 was designed to encourage hotel owners to "refurbish, repair and renovate their facilities" because Hawaii's aging visitor plant—especially hotel properties in Waikiki—has been (and remains) in dire need of major renovation to maintain Waikiki and the state as a competitive tourist destination.

In 1999, the Legislature passed Act 306 which removed the TAT cap and allowed the renovation credit to be applied either to the general excise tax, income tax, public service company tax, or the TAT.

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[8] State of Hawaii Department of Taxation (DoTax). *Tax Credits Claimed by Hawaii Individuals and Corporations*,1997 to 2000 annual reports, accessible at www.state.hi.us/tax

[9] Refundable tax credits "are any qualified amounts of credit regardless of tax liability." In other words, an investor can get a refund for qualifying capital expenditures on hotel renovation even if he owes no taxes. The TAT is an *ad valorem* tax of 7.25% of room rental receipts, and is added on to the 4% general excise tax levied on all final sales in Hawaii.

In 2000, the Legislature passed Act 195 granting a 4% refundable credit for hotel construction and renovation costs for taxable years beginning after December 31, 1998 and before January 1, 2003. Thus, Act 195 expanded the hotel credit base by allowing (new) hotel construction as well as remodeling expenditures to qualify for the tax credit. The Act further allowed the credit to be claimed retroactively on hotel construction expenditures incurred after December 31, 1998.

Following the September 11, 2001 terrorist attacks, the Hawaii Legislature enacted Act 10 which converted the 4% refundable hotel construction and renovation tax credit (Act 195) to a 10% *non-refundable* credit for qualifying expenditures incurred on or between November 2, 2001 and July 1, 2003; thereafter the 10% *non-refundable* credit reverts to a 4% *refundable* credit until the law sunsets on December 31, 2005.[10]

**Impact of Hotel Tax Credits on Capital Expenditures**

Exhibit 1 summarizes the number of claims under the various tax credit legislation and their dollar amounts for the tax years 1997-2001.

[10] Non-refundable credits "may be claimed against the taxpayer's net income tax liability for the taxable year." In most cases, excess credits—above the claimant's income tax liability—may be claimed against the taxpayer's future income tax liability until the qualifying credits are exhausted.

Exhibit 1: Hotel Tax Credits Claimed, 1997-2001

| Tax | Number Claimed | | | Dollar Amount | | |
|---|---|---|---|---|---|---|
| Year | Individuals | Corporations | Total | Individuals | Corporations | Total |
| 1997 | 20 | 36 | 56 | $ 35,000 | $ 894,000 | $ 929,000 |
| 1998 | 49 | 69 | 118 | 135,000 | 1,675,000 | 1,810,000 |
| 1999 | -- | 21 | 21 | -- | 1,174,000 | 1,174,000 |
| 2000 | 66 | 61 | 127 | 1,000,000 | 6,100,000 | 7,100,000 |
| 2001 | N.A. | N.A. | 259 | N.A. | N.A. | 7,400,000 |

Source: Hawaii Department of Taxation (DoTax). N.A. means not available.

In Exhibit 1 the dollar amounts may not be comparable for the period between 1997/98 and 1999/2000 because of the TAT cap before 1999, but the number of tax credits claimed should be comparable for all 4 years. That is because every taxpayer who qualified will have filed for the credit during these 4 years, but before 1999, the dollar amount that could be claimed by a taxpayer was capped at 10% of the TAT paid in the preceding year.

For 2001, two separate credits apply to hotel remodeling and construction spending; expenditures incurred before November 2 must file under Act 195, and the rest under Act 10. Indeed, the 259 claims in 2001 totaling $7.4 million—196 claims for $5.7 million under Act 195 and 63 claims for $1.65 million under Act 10—were filed by 201 different taxpayers. [11] As most of those who filed for the 10% credit also filed for the 4% credit[12], the full impact of Act 10 on investment decisions did not kick in until at least 2002. For 2001, the average size of the credit per claim under the 4% refundable credit was $29,082, while the average value per claim under the 10% non-refundable credit was $26,190. The gap widens when we convert the claims to equivalent dollar values of construction

[11] Letter from Kurt Kawafuchi, Director of Taxation to Representative Dwight Takamine, Chair, House Finance Committee, dated April 28, 2003.
[12] Ibid.

expenditures; the implied average value of construction spending per claim under the 4% credit was $727,040 and $261,905 under the10% credit. The main reason for the difference in the mean values of the construction spending under the two Acts in 2001 was most likely due to the fewer number of months Act 10 was in effect. To illustrate, suppose construction spending were evenly distributed throughout the year, the average qualifying construction spending per month under Act 195 would have been $72,700; by comparison, the implied average monthly construction spending per claim under Act 10 was nearly $131,000.[13] Thus, the average monthly construction spending per claim under Act 10 was actually much larger than under Act 195.

Exhibit 1 also shows that both individuals and corporations filed for the various hotel credits, but the bulk of the credits (in dollars) went to corporations rather than to individuals. On average, the dollar value of corporate claims was much larger (Exhibit 2).

Exhibit 2: Dollar Amount Per Claim

| Tax | Dollars ($) Per Claim | |
|---|---|---|
| Year | Individual | Corporation |
| 1997 | $ 1,750 | $ 24,833 |
| 1998 | 2,755 | 24,275 |
| 1999 | -- | 55,905 |
| 2000 | 15,152 | 100,000 |
| 2001 | N.A. | N.A. |

Source: Computed from information in Table 1.

[13] The expenditure estimates were computed by dividing the average value of the claim under Act 195 by .04 and the average value of the claim under Act 10 by .1. The actual amount of construction spending could have been higher than $113,000 under Act 10 if hotel industry losses following the September 11, 2001 terrorist attacks capped the size of the refunds.

As well, the lion's share of the claims were on Oahu (i.e. primarily Waikiki); for example, in tax year 2000, 95% of the dollar amount and 70% of the claims were on Oahu.

Did the hotel credits spur hotel capital (construction) spending? Exhibit 3 suggests that they did, as total hotel remodeling and construction expenditures increased dramatically by nearly 6-fold since 1997. Moreover, Exhibits 1 and 2 demonstrate that the number of claims as well as the dollar value per claim rose sharply since 1997.

Exhibit 3: Total Hotel Construction and Remodeling Expenditures

| Tax Year | Dollar Value (in millions) |
|---|---|
| 1997 | at least $ 23.2 |
| 1998 | 45.3 |
| 1999 | 29.4 |
| 2000 | 177.5 |
| 2001 | at least 159.0 |

Note: Computed by dividing the aggregate dollar value of the credits by the applicable credit rates.

Not everyone agrees that the hotel tax credits have spurred hotel capital spending. Critics of the hotel tax credits have argued that they were an unnecessary subsidy because the qualifying hotel construction expenditures would have occurred anyway. For example, in explaining the big increase in the value of hotel credits in 2000, the Hawaii Department of Taxation (DoTax) noted that more than half of the increase was the result of one large Waikiki project begun in 1999, meaning that the decision to build the new Waikiki hotel property was made before the passage of Act 195.[14] Indeed, the Act's retroactivity

[14] Letter from Kurt Kawafuchi, Director of Taxation to Representative Dwight Takamine, Chair, House Finance Committee, dated April 28, 2003, p. 2.

provision enabled the owners of the new hotel property to receive a tax windfall in 2000. The Director of DoTax concluded that "tax incentives, alone, cannot be credited with increasing total renovation and construction investment."[15]

Tax credits were not the only factor that may have motivated hotel construction and renovation expenditures. Hotels affiliated with upscale hotel chains such as Hilton and Sheraton that have international reputations for standardization and quality, must maintain their properties on an on-going basis regardless of whether tax credits are available to help pay for the renovations.[16] Falling interest rates may also have stimulated capital spending during this period. To the extent that the decline in interest rates would have affected total construction spending in the State, not just hotel renovation and construction, DoTax records show that total "construction put in place" in Hawaii increased less dramatically (in percentage terms) than hotel remodeling and construction spending during the same period, rising from about $3.1 billion in FY1997 to $4.0 billion in FY 2002.[17]

We also conducted our own interviews with owners and investors of nine newly renovated hotels to ascertain whether the hotel tax credits influenced their renovation expenditure decisions (more on the interviews later). Several developers stated that their

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[15] Ibid.

[16] Renovation may also be motivated by a global positioning strategy decided at the corporate chain headquarters rather than by local factors; for example, after acquiring the Sheraton brand from the ITT Corporation in 1998, Starwood Hotels & Resorts spent more than $1 billion primarily on renovations of its newly acquired Sheraton properties worldwide to upgrade the Sheraton brand. *Travel Weekly Daily Bulletin*, Article ID=37783 at www.twcrossroads.com/

[17] The fiscal year (FY) in Hawaii runs from July 1 until June 30 of the following year; for example, FY 1997 runs from July 1, 1996 to June 30, 1997. The value of total construction put in place each year was $3.066 billion in FY 1997, $2.969 billion in FY1998, $2.974 billion in FY1999, $3.341 billion in FY2000, $3.701 billion in FY 2001, and $4.006 billion in FY2002. On a calendar year basis, total construction put in place increased from $2.9 billion in 1997 to $3.7 billion in 2001.

projects would not have proceeded without the 4 percent refundable credit, or that the credit was a factor in reallocating funds from other U.S. mainland projects to Hawaii and/or had impacted the timing of their investments. Furthermore, most owners reinvested the credit into the hotel by adding the value of the credit to the renovation budget. Thus, the responses from hotel owners and investors lend additional support to the claim that the hotel credits played a strategic role in their capital expenditure decisions.

**Impact of Hotel Tax Credits on the Performance of Renovated Hotels**

Analysis of the effects of renovations at the nine major hotels where we conducted interviews finds that each renovation either resulted in a major property transformation and reposition, or helped the hotel regain market positioning previously lost due to deferred maintenance or physical obsolescence. Prior to renovation most of the nine hotels suffered from substantial deferred maintenance and/or from having financially unstable owners; several of the hotels were in foreclosure. Exhibit 4 shows the renovation budgets for the nine hotels.

Exhibit 4: Renovation Budgets of Nine Selected Hawaii Hotels, 1997-2001

| | Year Renovated | # rooms | Estimated Renovation Budget |
|---|---|---|---|
| **Aston Waikiki Beach** | 2001-02 | 716 | $23 Million |
| **W Hotel Honolulu** | 1997 | 49 | $10 Million |
| **Waikiki Beach Marriott** | 2001-02 | 1310 | $60 Million |
| **Renaissance Ilikai** | 2001 | 783 | $25 Million |
| **Turtle Bay Resort** | 2001 | 443 | $30 Million |
| **Westin Maui** | 2000-01 | 759 | $17 Million |
| **Outrigger Waikoloa** | 1999 | 545 | $26 Million |
| **Outrigger Wailea** | 2001 | 521 | $25 Million |
| **Ohana Keauhou Beach** | 1999 | 310 | $17 Million |

Source: Hawaii Hospitality Magazine / Hospitality Advisors LLC

Exhibit 5 – Renovation and Repositioning at Nine Selected Hotels

| | **Market Positioning** | |
|---|---|---|
| | **Before Renovation** | **After Renovation** |
| **Aston Waikiki Beach** | Lower-Tier Midprice | Upscale |
| **W Hotel Honolulu** | Budget | Upper-Tier Upscale |
| **Waikiki Beach Marriott** | Upper-Tier Midprice | Upper-Tier Upscale |
| **Renaissance Ilikai** | Midprice | Upscale |
| **Turtle Bay Resort** | Budget | Upscale |
| **Westin Maui** | Lower-Tier Upscale | Upper-Tier Upscale |
| **Outrigger Waikoloa** | Midprice | Upscale |
| **Outrigger Wailea** | Midprice | Upscale |
| **Ohana Keauhou Beach** | Budget | Midprice |

Source: Smith Travel Research / Hospitality Advisors LLC

Exhibits 5 and 6 show that the renovations undertaken at the nine hotels allowed them to reposition their products upward to appeal to a higher spending visitor segment and thereby achieve higher hotel average daily room rates ("ADR") and revenue per available room. Hotel performance data provided by Smith Travel Research indicate that prior to the renovations the market performance of these properties was fairly stable; however, after renovation both ADR and room revenues showed strong gains for the entire group.

Table 6 – Comparison Average Daily Rate and Revenue Per Available Room

| | **Year** | **Average Daily Rate** | **Revenue Per Available Room** |
|---|---|---|---|
| **Before Renovation** | 1997 | $99.07 | $72.04 |
| | 1998 | $99.24 | $65.49 |
| | 1999 | $94.87 | $58.54 |
| **After Renovation** | 2000 | $126.72 | $88.92 |
| | 2001 | $134.82 | $80.03 |
| | 2002 | $128.71 | $86.41 |

Source: Smith Travel Research / Hospitality Advisors LLC

The gains exhibited by the nine renovated hotels is even more striking when we compare their average performance against the performance of the overall market (Exhibit 7). The nine renovated hotels experienced increases in room rates and revenue per available room that were well above that for all hotels through August 2001, just prior to the September 11, 2001 terrorist attacks. The conclusion of superior performance for the nine renovated hotels still holds even if we extend the comparison through the end of 2002.

Exhibit 7 – Comparative Market Performance Before after Renovation and Repositioning of The Nine Renovated Hotels (Pre-September 11, 2001)

| | Composite | | | Overall Market | | |
|---|---|---|---|---|---|---|
| | 1997 | YTD 8/01 | Δ% | 1997 | YTD 8/01 | Δ% |
| Occupancy | 72.7% | 66.7% | -8.3% | 73.7% | 75.3% | 2.2% |
| ADR | $99.07 | $160.79 | 62.3% | $125.86 | $148.60 | 18.1% |
| RevPAR | $72.04 | $107.17 | 48.8% | $92.76 | $111.88 | 20.6% |

Source: Smith Travel Research / Hospitality Advisors LLC YTD= Year to date.

**Economic Trickledown and Tax Revenue Recovery**

Renovation of the nine hotels carried an estimated budget totaling $233 million of which $145.5 million would have qualified for the hotel tax credits. A four percent refundable tax credit would have returned $5.8 million in one-time tax refunds to the hotels. Using the State's economic (input-output) multipliers, the qualifying renovation expenditures could be expected to generate $299.7 million in Statewide business sales , $96 million in household earnings, 2,779 jobs, and $16.7 million in State tax revenues.[18] Because the renovated hotels are able to charge higher room rates, they attract customers who are likely to spend more money on other vacation purchases as well thus generate even

[18] State of Hawaii, Department of Business, Economic Development and Tourism. *The Hawaii Input-Output Study, 1997 Benchmark Report* (2002), accessible at www.hawaii.gov/dbedt/97io/97i-o.pdf State tax revenues do not include tax revenues (e.g. property taxes) accruing to the counties.

more economy-wide business activity and tax revenues when they are returned to service.[19] We estimate that in the three years following their renovation, the nine hotels were able to generate a total of $91.8 million in additional room rental revenues above what they might have received without renovation, for an average annual increase of some $30 million. On average, hotel room expenses account for nearly one-third of total vacation expenses in Hawaii.[20] This means that guests of these nine hotels might have spent $90 million more per year on their Hawaii vacations (including lodging) than a less upscale group of guests had the hotels not been renovated.

It would be a stretch to attribute all the economic benefits described above solely to the hotel credits. If in each of these nine hotels the availability of tax credits tipped the decision in favor of going ahead with renovation, then the entire renovation budget should be attributed to the credits. But if hotels only added the value of the credits to renovation projects that had already been committed, then only $5.8 million of the total renovation expenditures can be attributed to the credit. The range between the two numbers is huge with the correct number lying somewhere between. The inability to derive more precise estimates of tax credit induced hotel capital expenditure presents a difficult challenge to lawmakers when weighing the costs and benefits of enacting tax incentive legislation. Nonetheless, available data strongly suggest that Hawaii's hotel tax credits did spur hotel remodeling and construction spending as lawmakers had intended.

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[19] For example, visitor expenditure surveys conducted by the Department of Business, Economic Development and Tourism (DBEDT) in 2002 found the following relationship between per person daily visitor spending on lodging and total daily spending:

| | Maui | Molokai | Lanai | Kauai | Big Island |
|---|---|---|---|---|---|
| Lodging | $62.02 | $28.41 | $173.22 | $51.71 | $52.11 |
| Total Spending | 160.99 | 83.28 | 247.37 | 142.66 | 140.73 |

**Policy Lessons**

In 1988, Hawaii enacted legislation allowing businesses that purchase capital goods[21] to claim a 4 percent *refundable* tax credit. The capital goods excise tax credit offsets Hawaii's broad-based 4% general excise tax levied on final sales; in essence, the credit exempts qualifying capital goods purchases from paying the excise tax. The purpose of the credit was to reduce business costs and enhance the state's competitiveness. Because the capital goods excise tax credit applies only to tangible "personal" --but not "real"—property, a hotel, for instance, can claim a 4% refundable credit for the purchase of a new computer, but not the cost of remodeling a hotel or building a new one. The asymmetry in the treatment of these two types of capital goods—equipment versus structures—is curious in that capital employed in tourism, Hawaii's leading "export", consists mostly of structures rather than equipment.[22] It attests to the lawmakers' commitment not to provide incentives to the hotel industry when the industry was obviously doing well until the 1990s. It took nearly a decade after the enactment of the capital goods excise tax credit before the Hawaii Legislature enacted similar legislation to induce hotel owners to renovate their properties.

Why did Hawaii's lawmakers change their mind? First, following the first Gulf War in 1991, Hawaii's economy stagnated for seven years, an "unprecedented" event in the

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[20] State of Hawaii Department of Business, Economic Development and Tourism (DBEDT). *Annual Visitor Research Report, 2001* (Honolulu: DBEDT, 2002), p.83.

[21] The capital goods must be depreciable and have a useful economic life of at least three years.

[22] Robert H. McGuckin and Kevin J. Stiroh, "Computers and Productivity: Are Aggregation Effects Important?" *Economic Inquiry*, vol. 40, no. 1 (January 2002), pp. 42-59. However, air and water transportation employ relatively more equipment than structures.

state's economic history.[23] Since gaining statehood in 1959, Hawaii had never experienced two consecutive years of economic recession. After half a decade of denial that the state's economic malaise was perhaps more than cyclical in origin, Hawaii's new governor and lawmakers embarked on a major effort to identify and implement far-reaching policy changes to revitalize the sagging economy. As in numerous other states, giving tax incentives was one of the economic remedies.

Second, Japanese travel to Hawaii took a steep plunge after 1997 and has declined every year since. The number of Japanese visitors to Hawaii reached a peak of 2.152 million in 1997 and has plunged to less than 1.5 million in 2002. While the huge numerical decline was alarming; even more alarmingly were statistics that showed that Hawaii's share of Japanese overseas travel fell from 12.8 percent in 1997 to 9.3 percent in 2001.[24] It was apparent to everyone that Waikiki, the flagship of Hawaii's tourist industry since statehood and the favorite destination among Japanese visitors to Hawaii, was losing its appeal relative to other newer destinations and that Waikiki's aging visitor infrastructure was partly to blame. Christopher Grandy observed that "…while everyone 'knows' that Waikiki must be refurbished, curiously, this has not happened."[25] Act 108, the first hotel renovation tax credit passed in 1997 was regarded by the state administration "as a way of jump-starting investment at a reasonable cost."[26] But Act 108 provided only two years of tax relief, not enough time to permit major renovation projects to be planned and completed. Subsequent

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[23] Christopher Grandy. *Hawaii Becalmed, Economic Lessons of the 1990s* (Honolulu: University of Hawaii Press, 2002).
[24] Data from the State of Hawaii, Department of Business, Economic Development and Tourism (DBEDT) and Japan Travel Bureau. Hawaii's share of Japanese overseas travel slid to 9.1 percent in 2002.
[25] Grandy (2002), p. 87.
[26] Ibid.

legislations became increasingly generous. What began as an inducement in 1997 (Act 108) to refurbish an aging infrastructure in Waikiki (i.e. a redevelopment tool) became a short-term economic stimulus tool (Act 10) after the September 11, 2001 terrorist attacks.

In 2003, the hotel industry lobbied heavily at the Legislature to extend the expiration date of the hotel tax credit, raise its rate, and broaden its scope of coverage to include the construction costs incurred on other commercial properties (e.g. restaurants and shops) located in designated resort areas. This effort prompted the largest circulation local newspaper to urge the state to "wean the hotel industry from state tax credits".[27] The paper argued that "While we appreciate that these breaks are intended to stimulate the economy, we'd prefer to see them used to foster fledging industries. It's imprudent for the state to keep subsidizing tourism projects that are part of what is, after all, a well-established industry."[28]

Why should a premier and "well- established" destination like Hawaii give tax credits to induce hoteliers to renovate their aging properties or to build new ones? Why doesn't the market work in Hawaii to induce the desired investment? The most likely explanation is that during the 1970s the Honolulu City Council imposed a ceiling on the number of hotel rooms permitted in Waikiki; the room cap effectively imposed a barrier to entry, stifled potential competition and produced high hotel occupancy rates that reduced

[27] "Wean hotel industry from state tax credits," *Honolulu Advertiser*, May 5, 2003, p. A8. Another heavily criticized tax credit bill would grant the developer of a "world class" aquarium at the Ko Olina Resort and Marina on Oahu up to $75 million in tax credits over a 10 year period.

[28] Ibid. While the paper criticized the hotel tax credit, it remained notably silent on the merits of the capital goods excise tax credit.

the incentive by hotel owners to renovate their properties.[29] Over the years strong political opposition from area residents against permitting more hotel rooms in Waikiki has kept the ceiling in place. Not surprisingly, much of Waikiki's hotel inventory was left to depreciate.[30]

During the 1990s, the room cap was not binding as travel to Waikiki declined as did hotel occupancy. Rising vacancies should have provided an additional incentive to hoteliers to renovate their properties. That did not occur for several reasons. First, Japanese owners of a number of major Waikiki hotels, acquired at inflated prices during the Japanese economic "bubble" of the late 1980s, found themselves unable to service their debts after the bubble burst in 1991 and they fell further behind in the maintenance of their properties. Second, high real estate prices fueled by the surge in Japanese investments in Hawaii during those "bubble" years followed by the sudden market collapse due to declining tourism demand attributable to the first Gulf War and economic recessions in Japan and the U.S. complicated ground rent renegotiations in the early 1990s for hotels built on leasehold land[31]; renovation was often deferred until future ground rents were renegotiated and

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[29] Renovation requires taking potentially occupied rooms out of service. Owners appropriately pencil in the opportunity cost of revenues lost as a separate project cost item in determining whether to renovate. Hence, artificially high occupancy rates due to the room cap reduce the owners' incentive to renovate.

[30] We thank Paul Brewbaker (Bank of Hawaii) and Dr. Pearl Imada-Iboshi (State of Hawaii, Governor's Office) for suggesting this explanation. One effect of the Waikiki hotel room cap was to push tourism to Hawaii's outer islands. Nonetheless, Waikiki remains the "flagship" of Hawaii's tourism industry, accounting for 45 percent of visitor units, 8 percent of total economic activity , and directly and indirectly accounts for 11 percent of all civilian jobs in the state and 12 percent of state and local tax revenues. State of Hawaii Department of Business, Economic Development and Tourism (DBEDT). *The Economic Contribution of Waikiki* (May, 2003) at www.hawaii.gov/dbedt/econ_waikiki/index.html

[31] The complication stemmed from the difficulty in reaching agreements on future ground lease rents when land values were trending downward but landowners demanded rents that

uncertainty was removed. Finally, in response to rising vacancy rates, a few hotel owners found it more profitable to withdraw aging hotel units from the vacation rental market, for example, by converting one hotel into a luxury senior retirement home, another into a residential condominium, and some hotel rooms into vacation time-share units.[32] Thus, several factors converged to discourage hotel renovation expenditures in the 1990s.

Hawaii's State Government, like governments everywhere, has a compelling interest in promoting state economic growth. In recent decades, efforts by the State Government to diversify Hawaii's economy away from tourism into other economic activities--and most notably into high technology—have produced few lasting successes. Given Hawaii's demonstrated comparative advantage in tourism, the best diversification strategy may well be found within tourism itself.[33] Destination life cycle theories suggest that Hawaii cannot count on tourism to grow indefinitely.[34] Hawaii's residents also do not want to have unlimited tourism growth. In 2001, the Hawaii State Legislature passed Act 259 commissioning a study on the "carrying capacity" of tourism in Hawaii and strategies to

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were based on inflated real estate values observed during the "bubble" period. In some cases, disagreements were resolved through binding arbitration.

[32] Such a "divestment" strategy is not unique to Hawaii. For example, in 2003 the Hyatt Hotel Corporation closed its Hyatt Regency Cerromar Beach Resort in Puerto Rico with the intent of converting it into a Hyatt Vacation Ownership facility. The company cited the "general business climate and the proliferation of newer and more modern competitors" for the decision to close the resort. *Travel Weekly Daily Bulletin*, Article ID=37859.

[33] David McClain, "What can Hawaii do to stay competitive in the world market and keep its economy strong?" in Randy W. Roth (ed.). *The Price of Paradise* (Honolulu: Mutual Publishing, 1992), pp. 7-13.

[34] See, for example, Richard W. Butler, "The Concept of the Tourist Area Cycle of Evolution: Implications for the Management of Resources," *Canadian Geographer*, vol. 24 (1980), pp. 5-12; and Stanley Plog, "Why Destination Areas Rise and Fall in Popularity, An Update of a *Cornell Quarterly* Classic," *Cornell Hotel and Restaurant Administration Quarterly*, vol 42, no. 3 (June, 2001), pp. 13-24.

achieve sustainable tourism.[35] Indeed, the Hawaii Tourism Authority's (HTA) 1999 Strategic Plan—*Ke Kumu*-- redirects its marketing and development strategies to attract higher spending visitors rather than more visitors. One way to achieve that goal is for the HTA "to be a strong advocate for investment in infrastructure and support services…particularly the revitalization of Waikiki and other key tourist destinations."[36] HTA's 2002 annual report to the Legislature notes that "Hawaii has many strengths, it also has an aging infrastructure and product."[37]

In the long run, HTA's effort to attract higher spending visitors can be realized only if Hawaii can offer a higher quality tourism product. Given the reluctance of Waikiki hotel owners to make major improvements on their properties, granting tax incentives to induce them to renovate their hotels or build new ones is not an unsound economic redevelopment strategy for Waikiki. The net social benefit to Hawaii could prove to be greater by directing the State's resources to redevelop "a well-established industry" in tourism rather than to "foster fledging industries." From the State's budget perspective, our analysis of the effects of remodeling on the nine hotels shows that the recovery of tax revenues expended under the various hotel tax credits began almost immediately after the investment, and not years after the investment. If tax incentives must be given to induce investment, research shows that "the preferred form of tax incentives are those that provide for faster recovery of investment costs."[38]

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[35] For details of this study, see www.hawaiitourismstudy.com The study is expected to be completed by the 2004 legislative session.
[36] Hawaii Tourism Authority (HTA). *2001 Annual Report*, at www.hawaii.gov/tourism/hta.2001.pdf
[37] HTA. *2002 Annual Report*, p. 20.
[38] Zee et. al. (2002), p. 1.

However, opening the door to the State's treasury to pay for the hotel tax credits creates a potential hazard. Hawaii's brief experience with hotel tax credits demonstrates that once the State reneged on its commitment not to grant incentives to the industry, hotel owners have learned that it can be profitable to expend resources to lobby for increasingly generous tax incentives. In the U.S. automobile industry, car manufacturers have found that once they began offering incentives to unload their unsold cars, many potential buyers have learned to wait for the next round of incentives before buying a new car, ultimately costing the automobile manufacturers profits. Like these new car buyers, hotel owners also can play this holdout game and withhold investment until lawmakers entice them to invest by offering increasingly generous incentives. The potential outcome of such a strategic game, if it is allowed to be played out, is that the main effect of tax incentives is to influence the timing of the investment and not to induce significantly more investment. Under those circumstances, incentives yield little long-term economic benefits to resident taxpayers but very high costs.

Finally, Hawaii's hotel tax credits have not proven themselves to be a significant short-term economic stimulus tool. A tax cut of $7 million per year (in tax years 2000 and 2001) cannot provide a significant economic stimulus to an economy with an annual gross domestic product in excess of $40 billion. In sum, the use of such tax credits can best be defended as a redevelopment tool and not as a short-term economic stimulus tool.

**Conclusion**

Despite their widespread use, tax incentives remain a controversial policy tool to induce and attract business investment. An extensive body of research has shown that state and local taxes do have an impact on business investment decisions, although "the effect

will be substantially smaller or greater in different cases."[39] At best the cost effectiveness of tax cutting incentives is judged to be "highly inconclusive". While our analysis of Hawaii's hotel tax credits cannot ascertain whether the benefits exceed the costs—the available data simply cannot support such an analysis--, it does suggest that, under the right circumstance, tax incentives can be a useful tool to accelerate the redevelopment of an aging destination such as Waikiki. Of course, the size of the incentive also matters in the outcome of the benefit-cost analysis.[40] Critics of tax incentives often argue that they merely shift the timing of investments and not spur more investment. Even if that were accepted to be true, compressing the time frame of investment is precisely what is needed when wholesale redevelopment of a destination is desired.

Governments just about everywhere are heavily involved in local and regional development projects because redevelopment is seen to generate community-wide benefits. In the case of Waikiki, while everyone wants it to be refurbished, no single hotel owner can (or is willing to) refurbish Waikiki on his own. By contrast, the government can effect the redevelopment of Waikiki through its direct participation and intervention and thus enable the destination to achieve its economic potential. Granting tax incentives is one way the government can induce private investment within a close time interval to create a critical mass of renewal. This helps to achieve a more successful destination-wide repositioning rather than piecemeal renovation.

[39] Fisher (1996), p. 631.
[40] See, Ibid., pp. 637-638.

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