

# **Political Economy of Property Tax Reform: Hawaii's Experiment with Split Rate Property Taxation**

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## **Abstract**

Economic theory suggests that switching from a general property tax to a split-rate tax increases land use efficiency and stimulates urban core development while preserving the environment and reducing urban sprawl. Under split-rate property taxation, land is typically taxed at a significantly higher rate than improvements (buildings). Since the mid-1960s, Hawaii lawmakers have experimented with the split-rate system to encourage economic growth and effect land reform. Recently, Kauai County has adopted the unusual practice of taxing improvements at a higher rate than on land. Kauai's "inverted" split rate property tax provides tax relief to residents who own and occupy modest homes and simultaneously exports taxes to the tourist industry and visitors. This paper chronicles and explains the rationale behind Hawaii state and county experiments with split rate property taxation.

**Keywords:** Property taxes, split rate property taxation, tourist taxes

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## I. Introduction

Nobel laureate in economics William Vickrey once observed that “The property tax is, economically speaking, a combination of one of the worst taxes—the part that is assessed on real estate improvements...and one of the best taxes—the tax on land or site value.”<sup>1</sup> Property tax reforms are an important part of ongoing attempts on the part of governments to raise revenue in efficient ways. In the U.S. most local communities tax real property—i.e. land and improvements-- at a single rate. However, a few communities notably in Pennsylvania—and most famously the city of Pittsburgh-- have experimented with splitting this rate into two components, levying one rate on the value of the land and another on the value of improvements (Hartzok, 1997; Oates and Schwab, 1997; Schwab and Harris, 1997; and Cohen and Coughlin, 2005). Typically, the tax rate on the value of the land is set significantly higher than that on improvements. Around the world, more than 700 cities use the split-rate property tax system (Cohen and Coughlin, 2005, p. 359).

Economic theory suggests that switching from a general property tax to a split-rate tax increases land use efficiency and stimulates urban core development while preserving the environment and reducing urban sprawl. Furthermore, theory predicts that the split-rate system can achieve these objectives while remaining revenue neutral and minimizing excess burden (Cohen and Coughlin, 2005; Schwab and Harris, 1997). Some researchers (e.g. Hartzok, 1997) believe that the ultimate goal is to eliminate the tax on buildings altogether and adopt a pure land tax, an idea that was most prominently promoted by political economist and social philosopher Henry George in his 1879 book *Progress and Poverty* (Mankiw, 2007, p. 169; Schwab and Harris, 1997. See also Bowman and Bell, 2008.) Indeed, the Connecticut Legislature recently introduced HB5357 which would permit cities to impose land value taxes (Brunori, 2009).

Hawaii's statewide experiment with split-rate property taxation began in the 1960's. As in other localities where split-rate taxation has been adopted, the legislation as passed in 1963 and repealed in 1977, stipulated higher tax rates on land than on improvements. In 1978, the State transferred power to levy property taxes to the four counties. In fiscal year 2006, Kauai County adopted the unusual practice of taxing improvements at a higher rate than on land resulting in an "inverted" split-rate property tax. Then in 2008, a bill was introduced in the Kauai County Council to greatly increase the ratio of tax rates on building values to land values. To understand fully the potential effects of such a policy, it is useful to study the circumstances behind its initial passage. This paper examines the political economy of property tax reform in Hawaii from Statehood in 1959 to the adoption of the unique inverted split-rate property tax on Kauai. We show how Hawaii's state and county governments tried to use the property tax as a political tool to effect economic and social change and to soften some of the pain (negative externalities) on local residents stemming from economic growth.

Section II describes briefly the Hawaii State Legislature's passage (in 1963) and implementation (in 1965) of a statewide split-rate property tax and its subsequent repeal (in 1977). Section III examines the different approaches to property taxation among the counties after the transfer of taxing powers from the State in 1978. Section IV describes the events and reasons leading up to the adoption of the inverted split rate property tax system on Kauai in fiscal year 2006 and the introduction of a property tax reform bill (Bill 2274) in 2008 which proposes to greatly widen the gap between property tax rates on buildings and on land. Section V concludes.

## **II. Enactment and Repeal of the Split-Rate Property Tax at the State Level**

The Pittsburgh Tax Plan, modeled on a similar assessment approach used in Pittsburgh, Pennsylvania, was passed by the Hawaii Legislature and signed into law by then Governor of Hawaii, John Burns in June 1963 (Act 142, Session Laws of Hawaii 1963) to take effect on January 1, 1965. Hawaii Revised Statutes, HRS 242, instituted separate rates of property taxation on land and on improvements. The law provided for real estate to be divided into six categories: residential, hotel, commercial, industrial, agricultural, and conservation. Of these, the first four categories would be taxed according to a split-rate system, but agricultural and conservation lands would be excluded. In addition, rates would be phased in according to a graded schedule. Over time, the law indeed increased the difference in rates on land and on improvements until the repeal of the Pittsburgh plan in 1977.

Hawaii presents an interesting case study in the experiment with the split-rate property tax. The state of Hawaii is unique in many ways. Geographically, it is an island state located in the middle of the Pacific Ocean that is separated from its nearest neighbor by 2,400 miles. Its largest industry currently is tourism. The *National Geographic Traveler* magazine (1999) includes Hawaii in its list of “50 Places of a Lifetime: The World’s Greatest Destinations.” It is the last of the 50 states to achieve U.S. statehood in 1959, and until the overthrow of Queen Liliuokalani in 1893, it was a functioning monarchy. Some believe that Hawaii’s highly centralized form of government today and its extreme concentration of land ownership are legacies of the monarchy. Following statehood, the islands were divided politically into four counties. The City and County of Honolulu comprises the entire island of Oahu and the northwestern islands of the Hawaiian chain. Hawaii County covers the entire island of Hawaii. Maui County includes the populated islands of Maui, Molokai, and Lanai. The County of Kauai includes the islands of Kauai and Niihau. Hawaii, Maui, and Kauai Counties are collectively

referred to as the Neighbor Islands. While the island (and county) of Hawaii (referred to by locals as the “Big Island”) is geographically larger than all the other islands combined, Oahu is by far the most populous (Table 1).

[Table 1 around here]

The explosive growth of tourism in Hawaii following statehood means that the resident population numbers displayed in Table 1 were greatly augmented by a sizeable and ever-growing tourist population. In 1960, the resident population of Hawaii was around 630,000, but the *de facto* population of Hawaii (which includes the number of tourists present minus the number of residents temporarily away) exceeded 651,000; for 2000, the corresponding numbers were 1.213 million and 1.338 million, respectively.

The state’s population in 1960 was very racially diverse. In addition to whites (202,000 in 1960) and Japanese (203,000), Filipinos (69,000), Chinese (28,200), and Koreans (7000), there was a sizeable native Hawaiian population (102,000) (Nordyke, 1989; State of Hawaii, DBEDT, 2006). Hawaii has been and remains unique among the 50 states for its racial diversity; no single racial group comprises a majority of the state’s population.

There are aspects of Hawaii’s history and set of background characteristics which are critical to an explanation of how and why the State passed and implemented this rather unusual experiment with property taxes. Three main factors led to the legislation (in 1963) and implementation (in 1965) of the split-rate property tax law. First, the 1960’s were years of astonishing growth in Hawaii’s economy. This growth quickly transformed what had been a predominantly agricultural economy based on sugar and pineapple exports into a service oriented economy based on tourism and the U.S. military (Hitch, 1992). The split-rate property tax

legislation was intended to further this growth by taxing idle land at a premium rate and creating a more open, competitive market for land.

The second important factor underlying implementation of the split-rate system in the 1960's was the high degree of centralization in Hawaii's system of state and local government (Meller, 1992; State of Hawaii Tax Review Commission, 1984). This centralization is related to the state-level provision of K-12 public education. Public schools in the U.S. are typically funded at the local district level and with significant amounts of local property taxes. However, public K-12 education in Hawaii is provided at the state level. The lack of local education funding in Hawaii obviates the need for local government to levy the high property taxes found in other states. The Hawaii State Constitution also places responsibility for the most costly functions of government at the state level. Thus, the State of Hawaii provides much of the expenditures on welfare, health and hospitals (Tax Foundation of Hawaii, 1969). The state's 1984 Tax Review Commission (p.1) concluded in its analysis of Hawaii fiscal system between FY1965 and FY1984 that "Compared to other states, Hawaii is fiscally centralized, with state government playing the dominant role. The degree of centralization has increased over time."

Throughout the 1960's and 1970's, Hawaii's state and local governments administered sixteen tax laws. Of these, fourteen were administered by the state government. Only the motor vehicle weight tax and the public utility franchise tax were administered by the four local counties (Tax Foundation of Hawaii, 1968, 1969a, 1971-1979). The limited powers to raise revenues led to limited responsibilities on the part of local county governments. The centralization of government function in Hawaii enabled the state to adopt a state-wide split-rate property tax system. In contrast, the experiments with split-rate systems on the U.S. mainland were enacted sporadically by a few local governments.<sup>2</sup>

The third crucial factor in Hawaii's passage and implementation of the split-rate system was political. The Democrats gained ascendancy in the 1960's against a backdrop of years of past Republican rule. The power base of the Republican Party was the Big Five, the consortium of five sugar factors who held most of the economic power and wealth in the islands. The first part of the twentieth century saw a high concentration of wealth, land ownership, and power in the hands of the Republicans. Land in Hawaii was more highly concentrated than in any other U.S. urban area (LaCroix and Rose, 1989). Furthermore, the geographical isolation of the islands precluded any substitutes for land in Hawaii (LaCroix and Rose, 1989). As a result, land in Hawaii has always been valuable and "has always been a political battleground and prize" (Cooper and Daws, 1985).<sup>3</sup>

In contrast to the mainly Caucasian dominated Republican Party, the Democratic Party was multi-ethnic and consisted of many Asian immigrants and their children. They came into office promising land reform. This meant "changes in the ownership, taxation, and use of land so as to benefit the ordinary person. And because there was no bigger item than land in Hawaii's politics, land reform was one of the biggest items on the Democratic agenda" (Cooper and Daws, 1985).

The Democrats' platform consisted of three main proposals, one of which was the Pittsburgh Tax Bill. In passing the Pittsburgh Tax Bill, the Democrats wanted to shift a greater burden of taxation to land while reducing taxes on homes, buildings, and productive agricultural land. One of the primary intended effects of the Pittsburgh plan was to force more land onto the market and encourage development (Hawaii State Archives, *Legislative Notes*). By forcing land onto the market, legislators also hoped to break up the large land estates and produce a more egalitarian distribution of wealth in the islands.<sup>4</sup> This political change combined with the

unique history of land and power in Hawaii contributed to the eventual implementation of split-rate property taxation.

The arrival of the split rate system in Hawaii was accompanied by higher average property tax rates in all four counties. In 1963, the state-wide average rate was \$14.75 per \$1000 net taxable property. In 1965, the average rate jumped to \$17.54 per \$1000 net taxable property; the rate on land was \$3.42 cents per \$1,000 net taxable property higher than before the implementation of tax reform while the rate on buildings was \$1.58 higher. However, the gap between the two in Hawaii was not remotely close to the five-fold or more difference observed in Pittsburgh (see Table 2); indeed, it was not even as wide a gap as the gap in Pittsburgh before that city embarked on its property tax reform in 1979 and 1980 (Oates and Schwab, 1997).

[Table 2 around here]

Although tax rates varied among the four counties, with Hawaii County levying the highest rates and Maui County levying the lowest rates, the tax rate on land was only about 11 percent higher than on improvements for all property types in all four counties, except for industrial properties in Hawaii County where the tax rate on land was nearly 16 percent higher. In the 1970s, the residential category was further divided into two separate categories: improved and unimproved residential. A single rate applied to improved residential properties while the split rate applied to unimproved residential properties. Where the split rate still applied, the gap between the tax rate on land and improvements had widened, but the rate on land was only 43 percent higher than the rate on buildings in all four counties.

The Pittsburgh Tax law survived for fourteen years. It was eventually repealed as residents' appetite for growth waned in the 1970's (Mak, 2008, Chapter 3). The advent of statehood in 1959, introduction of jet travel to Hawaii that same year, and the liberalization of

outbound tourist travel in Japan, and the robust U.S. and Japanese economies had quadrupled tourism in a decade, bringing with it dramatic increases in demand for hotel and tourism-related workers. With the local population unable to fill this demand, immigration soared. During his 1974 successful campaign for governor, Democratic Party candidate George Ariyoshi argued that “It is irresponsible for public officials to discuss Hawaii’s future in terms of unlimited growth.”<sup>5</sup>

In addition, the state experienced significant problems with implementation following passage of the Pittsburgh Tax Plan in 1963. The Plan was considered by some to be overly complicated, opaque, and inequitable. This is hardly surprising. Indeed, Cohen and Coughlin (2005) describe some of the practical problems encountered in administering a split-rate property tax system. In 1977, opponents of the split-rate structure won and the legislature repealed the split-rate system, re-instituting and gradually phasing in a single-rate system. By FY1982, while rates varied across the four counties, each county levied a single rate to land and improvements and to all classes of property.<sup>6</sup>

### **III. Return of the Split- Rate Property Tax at the County Level**

Repeal of the Pittsburgh Tax Plan in 1977 by the Hawaii State Legislature did not spell the end of the split-rate property tax system in Hawaii. Following the transfer of property taxing powers to the counties in 1978 (Hawaii Revised Statutes HRS 246A-2), each county now sets, assesses, and collects its own property taxes.<sup>7</sup> In FY 1982, all four counties in the state employed a single rate structure and applied a single county-specific tax rate on all property types. However, by FY1999, three of the four counties—Hawaii, Honolulu, and Kauai—had reinstated some version of the split-rate property taxation. Maui County alone elected to adopt a single rate structure.<sup>8</sup>

### *Hawaii and Honolulu Counties*

Between FY1983 and FY2002 Hawaii County imposed a higher tax rate—approximately 20 percent more—on land for all property types except improved residential and homeowner properties.<sup>9</sup> Thereafter, it adopted a single rate structure for all properties.

Honolulu County implemented a single rate structure, except during a 10-year period between FY1989 and FY1998. During this period, the county set higher rates on buildings on improved residential properties (see Table 3).<sup>10</sup> This was achieved by reducing the tax rate on land from \$6.56 per \$1,000 of taxable value to \$6.09 and keeping the tax rate on improvements unchanged.

[Table 3 around here]

Table 3 shows that rates on both land and buildings fell during the early '90s. This is not surprising given that housing prices on Oahu rose sharply in the late '80s. The tight housing market was associated with a decline in the number of available units for sale at any given time during this period (ACIR, 1989, p. 239). The run-up in real estate prices was widely attributed to speculative Japanese real estate investments.<sup>11</sup> Tax Foundation of Hawaii President Lowell Kalapa recalls that the change in property tax policy on improved residential properties was largely a political “backlash” against the wave of foreign, specifically Japanese, purchases of expensive homes in Honolulu beginning in the late 1980s.<sup>12</sup> The University of Hawaii’s Real Estate Research and Education Center found that in one neighborhood, Japanese buyers paid an average of 21 percent over estimated market value. Anecdotally, one Japanese billionaire investor purchased 100 homes in upscale East Honolulu and indicated that his goal was to purchase up to 1,000 homes on Oahu (Mak and Sakai, 1992). He ended up purchasing 180 (Aguiar, 2009). Between 1987 and 1990, the median price of single family homes on Oahu rose

from \$185,000 to \$352,000—an increase of 90 percent in three years (Mak and Sakai, 1992). While Japanese investments may have driven up prices in some neighborhoods, they were not the primary cause of the general housing price inflation in Honolulu. Median housing prices also spiked in the other counties where Japanese investment did not play a significant role in the residential home markets (Scontras, 2009).

#### *Kauai County*

Kauai County's experiment with split-rate property taxation was somewhat different from that of Hawaii and Honolulu counties. Two destructive hurricanes (Iwa in 1982 and Iniki in 1992) caused massive physical and economic damage to Kauai. Lawmakers on Kauai may have intended to provide fiscal incentives to facilitate reconstruction and generate jobs and income.<sup>13</sup> In any case, between FY1984 and FY2005 land for all property classes was taxed at a higher rate than on improvements for all property classes. However, beginning in FY2006, the county did an about face and levied higher tax rates on buildings than on land for residential (single family and non-owner occupied apartments), commercial, industrial, and hotel/resort properties. Table 4 presents the structure of property tax rates on Kauai for FY2006. The inverted structure of Kauai's 2006 implementation of split-rate property taxation is, at first glance, puzzling. In the following section, we examine the reasons for its adoption.

#### **IV. Political Economy of Enacting Kauai's Inverted Split Rate Structure**

Beginning in late 1998, property values jumped sharply on Kauai (Youn, 2003; Sommer, June 19, 2004; Scontras, 2009). As Table 5 indicates, residential property tax assessments rose rapidly after 2000.

[Table 5 around here]

Alarmed citizens pressured lawmakers to enact property tax relief.<sup>14</sup> The County established a nine-member Real Property Tax Task Force (RPTTF) whose mission was “to create a tax model which provides predictability, equity, and clarity.”<sup>15</sup> The Task Force met in over 28 meetings and in October 2004 unveiled a series of specific recommendations. It suggested that the base assessed value of properties be established by the average of assessed values between 1999 and 2003. Thereafter, annual increases would be indexed to the general inflation rate (Honolulu CPI-U). 1999 was chosen as a starting date because property prices on Kauai had begun to escalate in late 1998. It also recommended that the eight different property tax classes be reduced to two: (1) “Long-Term Residential” for properties which are occupied by their owners and/or long term tenants; and (2) “General” for all other properties. Tax rates on “Long-Term Residential” properties would be set at \$2 for land and \$6 for buildings for every \$1000 in assessed value. On “General” properties, the tax rate would be \$4 for land and \$12 for buildings for every \$1000 in assessed value. In sum, buildings would be taxed at rates three times that on land. Exemptions would remain unchanged. The inverted property tax was seen to be a way to provide property tax relief for people who own modest homes and to insulate them against sharply rising land values (Chuan, 2004).

Draft Bill 2108, which incorporated these recommendations, did not receive a public hearing at the County Council because council members felt that it would undermine the Council’s taxing authority (Finnegan, 2008). But the rising chorus of demand for action could not be ignored by Kauai lawmakers (Schaefers, 2005). The County Council initially enacted a temporary fix, capping annual property tax bill increases on homes owned and occupied by residents at two percent, and six percent for residents who put their second homes into long term rentals (Eagle, June 2, 2008). The mayor further proposed and the Council reduced tax rates on

land for almost all properties.<sup>16</sup> The mayor explained that he wanted to provide tax relief to all property owners and not just homeowners. This resulted in a rate structure that imposed slightly higher tax rates on buildings than on land for residential, commercial, hotel/resort, and industrial properties (Table 6).

[Table 6 around here]

The relatively higher tax rates on buildings and improvements automatically shifted a greater share of the overall property tax burden to hotels/resorts and non-owner occupied apartment units, condos, and timeshares from other property types. In FY2006, 75 percent of the taxable value of “hotels/resorts” and nearly 73 percent of the taxable value of “apartments” (which comprised of non-owner occupied units in multi-unit residential buildings, condos and timeshares) were in improvements; by comparison, improvements comprised less than one-third of the taxable value of all other property types and less than 25 percent on single family residential properties.

In the interest of long-term property tax reform, the Council appointed an eight-person Real Property Tax Committee (RPTC) to study and recommend a durable solution. Following nearly a year of deliberation, the RPTC proposed a real property tax reform package which the mayor sent to the County Council on May 30, 2008 (The County Council of Kauai, Bill 2274).

Bill 2274 (2008) abolishes the temporary measures enacted in 2005, including the popular two percent cap on owner-occupied homes. It replaces them with a “revenue neutral” package of proposed changes including one key proposal from the 2004 Kauai Property Tax Task Force, namely, a 3-to-1 ratio of building to land tax rates (Table 6).<sup>17</sup>

Eric Knutzen, the county facilitator to the RPTC, explained that “We’re putting the emphasis and taxation burden on the building side. The improvements on the land are really what drive the usage of county services.” (Eagle, July 10, 2008, p. A6) In other words, the plan is based on the benefit principle of taxation by taxing according to use of county services.<sup>18</sup> However, Pollock and Shoup (1977, p. 68) have shown that “a tax on building value tends to reduce investment in construction of improvements below the level supplied in the absence of the tax.” In other words, if the tax rate is shifted from land to buildings, with total property tax revenues held constant, the return to capital invested would fall and thus that parcel of land will be less intensively developed. The proposal, if enacted, would tend to discourage construction spending in the county.

The bill also raises dramatically the amount of exemptions for resident homeowners to among the highest levels in the state (Eagle, July 10, 2008)<sup>19</sup>. For example, the basic exemption for homes owned and occupied as principal residences would rise from \$48,000 to \$300,000. The \$300,000 would be applied to the building value first, further reducing the ratio of net assessed building to land value. For many owner-occupants of modest homes, the order in which the owner-occupant exemptions are applied under tax reform could reduce their taxable building values—which otherwise would be subject to the higher tax rate--to zero. In addition, the bill reduces the number of classifications from eight to four: (1) residential, which includes owner-occupied homes and long-term affordable rentals; (2) resource lands—which include conservation lands and “farmsteads” principally used for food, fuel, or fibre production; (3) “general”; and (4) resort.

Properties under the resort classification and non-owner occupied apartment units, condos, and timeshares are expected to bear the brunt of the change as they potentially have to

pay the highest tax rates and the 3-1 split ratio also hits them harder than other classes of property because they have much higher ratio of building values to land values. In sum, the proposed property tax reform package represents a blatant effort by its proponents to shift a greater share of the county's overall tax burden to tourism and non-permanent residents and away from homeowners and owners of agricultural and conservation properties. While it is not unusual for governments to design their tax systems to export taxes to nonresidents (Gade and Adkins, 1990), the architects of the plan reasoned that tourism is singled out for heavier taxation because tourists impose higher infrastructure costs on the County. Mayor Baptiste explained that he proposed the reform package to encourage housing availability, true agriculture, alternate energy production, and the preservation of the island's rural character (Eagle, July 10, 2008).

Table 7 shows the distribution of revenue increases and decreases and their shares of total county tax collections under the proposed four property classifications.

[Table 7 around here]

With tax reform, tax revenue from the residential category is expected to fall by an average of 31 percent with its share of total annual county tax revenue falling from 16 percent to 11 percent while the hotel/resort classification's tax bill would increase by 24 percent and its share of total revenue rise from 19 percent to 23 percent. The proposed changes amount to a \$3.75 million per year in additional tax revenues from the 3,595 parcels in the resort category<sup>20</sup> and a \$4.08 million decrease on the 11,125 parcels in the residential category.<sup>21</sup>

In September 2008, the Council decided to defer Bill 2274 because it could not muster sufficient support to pass it. Opposition to the proposed bill came from diverse groups. The resort community argued that the 3-1 split ratio would reduce the incentive for them to investment in their properties and would harm their competitiveness in the long run (Eagle,

September 5, 2008). Owners of timeshare units also objected. The chair of the County Council wondered whether this was the time to enact property tax reform since the economy was in a “tailspin”. Homeowners were apprehensive about the elimination of the two percent cap on property tax bills because they liked the “security and predictability” of the cap (Eagle, August 22, 2008; Eagle, August 19, 2008)<sup>22</sup>. Many residents who testified at the bill’s public hearings and workshops wanted the council to devote more time to study the proposals to make sure that it would not have negative unintended consequences. (Eagle, September 20, 2008). With the State’s tourist industry and economy in sharp decline and with home values falling in late 2008, there was less political pressure on council members to provide immediate homeowner property tax relief.

However, Kauai residents have not rejected the inverted split rate property tax system which they still have. Because current rate differences on buildings and on land are small, the present rate structure provides a modest amount of tax relief to resident homeowners. It penalizes hotel/resort owners and tourists (to the extent that taxes on improvements are at least partly passed on), though not by much given the modest size of the local property tax burden in a state where property taxes play a relatively small role in financing state and local public services. Anti-development groups are presented a tax system that is, at least on the surface, anti-development. Pro-development groups recognize this system is not in their best economic interest because of the potential loss of construction activity, tourism and income. However, they accept the outcome in exchange for assurances of lower property taxes as partial compensation. As a result, the current system achieves political equilibrium. The latest proposal to tilt the tax structure even more by tripling the size of the tax gap on buildings versus that on land is a

different cup of tea. The potential gains and losses to different stakeholder groups become much larger; hence it would be much more difficult to achieve political equilibrium.

It is noteworthy that potential losses in tourism related construction activity is not the primary reason for the deferment of property tax reform. Among Hawaii's residents, the citizens of Kauai have historically been the least supportive of tourism growth despite the fact that since the 1980s Kauai residents have had the second lowest per capita income among the four counties (State of Hawaii, 2008, Table 13.10). Kauai County's *General Plan for 2000* (Vision for Kauai) expresses the residents' vision that "... in 2020, Kauai will be a rural place whose population size and economy have been shaped to sustain Kauai's natural beauty and lifestyle." The Plan further emphasizes (p. 2-9) "While it is a major visitor destination, Kauai maintains its rural character. Limited in height and size, visitor accommodations and attractions are designed to complement the rural setting." Kauai's recently (HTA, 2006) completed strategic tourism plan (2006-2015) does not express a desire for rapid tourism growth; indeed, the residents of Kauai only want "modest" tourism growth. The Hawaii Tourism Authority's *2006 Survey of Resident Sentiments on Tourism in Hawaii* shows the following distribution of responses to the statement about more hotel development (Marketing Trends Pacific Inc. and John M. Knox & Associates, 2006).

Statement: Even if more visitors come, I don't want to see any more hotels on this island.

	<u>Oahu</u>	<u>Maui</u>	<u>Hawaii</u>	<u>Kauai</u>
Strongly Agree	45%	50%	38%	58%
Somewhat Agree	21	21	18	14
Somewhat Disagree	15	8	9	10
Strongly Disagree	14	19	32	17
Don't Know/Refused	5	3	3	1

In 2006, the Kauai County Council passed a resolution not to support any further zoning changes for resort development (HTA, 2006, p. 16). The County Council has also supported efforts to reduce the density of visitor-related projects that had already received approval (HTA, 2006, p. 16). In 2008, Kauai had 9,203 visitor accommodation units compared to 19,653 units for Maui County, 11,240 units for Hawaii County, and 34,081 units for Oahu (State of Hawaii, 2008 *Visitor Plant Inventory*).

In the 1990s, the residents of Kauai successfully thwarted the State Department of Transportation's plan to extend the main island's airport runway to accommodate jumbo jets that would have facilitated direct flights to Kauai from the U.S. mainland and Japan.<sup>23</sup> In 2007 a group of Kauai protesters stopped a private ferry company—the Hawaii Superferry—from offering the only inter-island ferry service between Oahu and Kauai.<sup>24</sup> Dayton and TenBruggencate (2007) suggest that the Superferry incident was not just a protest by a minority of Kauai residents but the result of majority anti-tourism and anti-growth sentiment. The late Kauai County Mayor Bryan Baptiste acknowledged that “Kauai has had a tendency to put a lot of barriers in front of development.” (Youn, 2003).

## **V. Conclusion**

One of the touted virtues of the staid property tax is that it is widely considered to be a stable and reliable source of tax revenue to fund public services. This paper has demonstrated that it can also be a political instrument to promote economic and social change. Whether it leads to good or bad policies is another matter.

In the 1960s and until the state government was required by constitutional amendment to turn over the property tax to the counties, Hawaii lawmakers adopted a statewide split-rate property tax system in which land was taxed at a higher rate than improvements. This policy satisfied political goals of the period: namely, to promote economic growth and effect land reform. Fourteen years later, the plan was repealed when high levels of growth became less desirable and urban planning shifted toward greater use of green and open-space principles. Whether the reforms produced the desired social outcomes remains empirically untested. Empirical studies on the aggregate long-term economic effects of split-rate property taxation elsewhere have not yielded conclusive results (Schwab and Harris, 1997, and Pollock and Shoup, 1977). Following its transfer to the counties, the property tax was used by the City and County of Honolulu in the late 1980s and 1990s to punish foreign investors who were blamed for driving up housing prices in Honolulu even though there is substantial evidence to show that it was not foreign investment, but supply constraints, that explains the run-up in housing prices in Honolulu.

Between FY1984 and FY2005 Kauai retained the standard split rate property tax where land was taxed at a higher rate than on improvements. This was a wise decision as it provided added incentive to rebuild structures after two massive hurricanes (Iwa in 1982 and Iniki in 1992) had caused substantial and widespread physical damage in the county.

Recently, Kauai County adopted the highly unusual practice of taxing improvements at a higher rate than land. A current bill proposes to greatly increase the relative tax burden on improvements. With only the property tax under its control, Kauai is counting on this creative strategy (in combination with higher homeowner exemptions) to provide tax relief to residents who own and occupy modest homes, save agricultural and conservation lands from intensive development, and simultaneously to export taxes to the tourist industry and visitors. As in the statewide split-rate system of the 1960's and 1970's, Kauai's property tax reform plan today is also driven by political and social aims. We conclude that an inverted split rate property tax system may work well for Kauai and some communities which desire slower and lower density development but may not work as well for others that do not embrace those values.

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Table 1

Population and Political Subdivisions in Hawaii: 1960 and 2000

	Land Area (sq. mi.)	Resident Population in 1960 (thousands)	Resident Population in 2000 (thousands)
State	6422.6	632.8	1211.5
Honolulu County			
Oahu	596.7	500.4	876.2
Hawaii County			
Hawaii (Big Island)	4028.0	61.3	148.7
Maui County			
Maui	727.2	35.7	117.6
Molokai	260.0	5.0	7.4
Lanai	140.5	2.1	3.2
Kauai County			
Kauai	552.3	28.0	58.3
Niihau	69.5	.3	.2

Source: State of Hawaii, DBEDT, *2005 State of Hawaii Data Book*.

Table 2

Property Tax Rates in Hawaii by Property Type in 1965  
(Per \$1,000 Net Taxable Property)

Property Type	State Average			Highest vs. Lowest Amongst Counties	
	Land	Improvements	Ratio	Land	Improvements
Residential	\$18.16	\$16.32	1.1127	\$18.47-\$15.64	\$16.68-\$14.08
Hotel/Apts.	18.39	16.57	1.1098	\$18.86-\$15.64	\$16.97-\$14.08
Commercial	18.37	16.50	1.1133	\$18.83-\$15.73	\$16.96-\$14.15
Industrial	18.21	16.33	1.1151	\$19.84-\$15.99	\$17.14-\$14.39
Agricultural	16.95	16.95	1.0000	\$17.90-\$15.00	\$17.90-\$15.00
Conservation	17.41	17.41	1.0000	\$17.90-\$15.00	\$17.90-\$15.00

Notes: (1) Hawaii County had the highest tax rates and Maui County had the lowest rates for all property types. (2) Section 8 HRS 248-2 requires a single rate to be applied to agricultural and conservation properties.

Source: Tax Foundation of Hawaii, *Government in Hawaii: A Handbook of Financial Statistics* (annual).

Table 3

Property Tax Rates on Improved Residential Properties in Honolulu  
 FY 1989-FY1999 (\$ per \$1,000 net taxable property)

	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99
Land	\$6.09	\$6.09	\$4.70	\$3.25	\$3.12	\$3.12	\$3.12	\$3.12	\$3.12	\$3.12	\$3.49
Buildings	6.56	6.56	4.95	4.09	3.92	3.92	3.92	3.92	3.92	3.92	3.49
Bldgs/Land	1.08	1.08	1.05	1.26	1.26	1.26	1.26	1.26	1.26	1.26	1.00

Source: City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division at <https://www.realpropertyhonolulu.com/portal/rpadcms/Reports?parent=REPORTS&code=-1>

Table 4

Property Tax Rates in Kauai County: FY 2006 (\$ per \$1,000 net taxable property)

<u>Property Type</u>	<u>Land</u>	<u>Buildings</u>	<u>Buildings/Land</u>
Single family residential	\$4.00	\$4.30	1.08
Apartment	6.95	7.95	1.14
Commercial	6.95	7.95	1.14
Industrial	6.95	7.95	1.14
Hotel and Resort	6.95	7.95	1.14
Agricultural	6.95	4.30	.62
Conservation	6.95	4.30	.62
Homestead	4.00	3.44	.86

Source: City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division.

Table 5: Gross Assessed Property Tax Values for Residences, Kauai  
County FY1993-FY2009

(Assessed Value Per Parcel, in thousands \$)

Property Type	FY1993	1997	2000	2003	2006	2009
Single Family	207	209	188	252	528	712
Apartment	247	186	169	206	489	485
Homestead	192	210	182	207	446	575

Source: City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division, at <https://www.realpropertyhonolulu.com/>

Table 6

Current vs. Proposed Property Tax Rates (\$ per \$1000 net taxable property)

Property Classification	Current		Proposed	
	Building	Land	Building	Land
Single Family Residential	\$4.25	\$3.95	\$10.50	\$3.50
Apartment	7.90	6.90	10.50	3.50
Commercial	7.90	6.90	10.50	3.50
Industrial	7.90	6.90	10.50	3.50
Agricultural	4.25	6.90	10.50	3.50
Conservation/Resources	4.25	6.90	7.50	2.50
Hotel & Resort	7.90	6.90	11.25	3.75
Homestead	3.44	4.00	6.00	2.00

Source: County of Kauai, *Proposed Real Property Tax Improvements* (2008), p. 22.

Table 7

Revenue Implications of Tax Reform vs. Current System

Property Type	# of Parcels	Revenue increase (+) or decrease (-)	% Change	% of Total Revenue	
				Current	Proposed
Residential	11,125	-\$4.081 million	-30.72%	16.14%	11.00%
Resource lands	1,077	- .740	-64.67	1.39	.48
General	13,695	+ 2.461	+ 4.73	63.21	65.10
Resort	3,595	+ 3.748	+23.66	19.26	23.42

Source: County of Kauai, *Proposed Real Property Tax Improvements*, (2008), p. 24.

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## End Notes

<sup>1</sup> Quote from Cohen and Coughlin, 2005, p. 359.

<sup>2</sup> The degree of centralization in Hawaii's system of state and local government shifted in 1978 when the State Constitutional Convention forced the State to turn over administration of the real property tax to local county governments. Article VIII, Section 3 of the Hawaii State Constitution (see Lee, 1993, pp. 143-144).

<sup>3</sup> Also Daws (1968), p. 395.

<sup>4</sup> The legislature also passed a landmark land reform bill in 1967 known as "mandatory leasehold conversion" which forced large landowners to sell their fee simple interests under leasehold single family homes to homeowners (King and Roth, 2006, pp. 81-82; Mak, 1992).

<sup>5</sup> Coffman (2003), pp. 241-244. At Ariyoshi's urging, the 1977 Legislature also passed a bill requiring a one-year residency requirement for local government employment, a measure that was invalidated by the federal district court.

<sup>6</sup> The tax rate per \$1000 of assessed value was \$15.23 for Oahu, \$7.50 for Maui, \$17.90 for Hawaii, and \$14.50 for Kauai.

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<sup>7</sup> However, HRS 246A-2 provided that “For a period of eleven years commencing November 7, 1978, the counties shall, by majority agreement of the counties, provide for uniform policies and methods of assessment for the taxation of all real property throughout the State. The policies and methods shall include the assessment, levy, and collection of real property taxes. Upon agreement of the uniform policies and methods to be used for the taxation of all real property, each county shall adopt by ordinance such uniform policy and method of assessment as the real property tax law of the county.”

<sup>8</sup> As the fastest growing county in Hawaii, Maui did not appear to need any further fiscal incentive to spur development. See Table 1 (above) and Mak (2008), Chapter 8.

<sup>9</sup> In FY 1983, land under single family residential land was also taxed at a higher rate than buildings. Between FY 1985 and FY2002, the land tax rate was held constant at \$10.00 per \$1,000 of net taxable property while buildings were taxed at \$8.50.

<sup>10</sup> Higher rates on buildings also applied to apartments but only between FY1989 and FY 1991. In FY 1983, Honolulu levied a higher rate on buildings for single and multi-family residential properties and on apartments and a single rate on all other properties.

City and County of Honolulu, Department of Budget & Fiscal Services, Real Property Assessment Division at

<https://www.realpropertyhonolulu.com/portal/rpadcms/Reports?parent=REPORTS&code=-1>

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<sup>11</sup> Others have pointed the finger at supply constraints. U.S. Advisory Commission on Intergovernmental Relations (ACIR) (1989), p.239. The ACIR noted that growth in the housing stock did not keep pace with rising population. Between 1960 and 1978, per capita housing units increased from one unit for every 4 residents to 1 unit for every 3 residents. But the ratio fell every year between 1979 and 1985.

<sup>12</sup> Personal conversation with Lowell Kalapa. The idea to raise property taxes on homes combined with a tax credit to rebate increases to resident home owners was one suggested remedy for unaffordable housing in Hawaii during the early 1990s. Ordway (1993), p. 128.

<sup>13</sup> The 1982 Hurricane Iwa also struck Oahu but inflicted relatively little damage because it missed the urban core. Kauai took the full brunt of Hurricane Iniki.

<sup>14</sup> Following the example of California's Proposition 13, in 2004 Kauai citizens voted to change the county charter to roll back property tax assessments and capped annual assessment increases on owner occupied homes; the vote was invalidated by the Hawaii Supreme Court in 2007 (See Sommer, October, 19, 2004; Zimmerman, 2007; Supreme Court of Hawaii, 2007).

<sup>15</sup> See [http://www.kauai.gov/Portals/0/Finance\\_RP/RPT\\_update\\_041015.pdf](http://www.kauai.gov/Portals/0/Finance_RP/RPT_update_041015.pdf)

<sup>16</sup> County of Kauai, Department of Finance News Release, May 6, 2005. The property tax rate on land under single family homes was reduced by 22.2 percent from \$5.20 per \$1000 value to \$4.00, and by 15.2 percent from \$8.20 per \$1000 value to \$6.95 on land under apartments, commercial, industrial, and hotel/resort properties. Tax rates on conservation and agricultural

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lands were also reduced—by 14.2 percent and 8.6 percent respectively—but they remained higher than the rates on buildings.

<sup>17</sup> As the County Council has the sole responsibility for setting property tax rates, the 3 to 1 ratio of tax rates is a proposal and not locked into the bill. It can be changed at any time by the Council.

<sup>18</sup> No quantitative evidence was presented on the relationship between building values and demand for county services.

<sup>19</sup> For those 60 and older, the exemption would rise from \$96,000 to \$325,000 and the current exemption of \$120,000 for residents age 70 and older would rise to \$350,000.

<sup>20</sup> The 1,629 hotel and resort condominium units would see an increase of \$1.63 million or \$1,001 per unit per year; the 1,841 timeshare units would see a \$2.1 million increase or \$1,142 per unit per year, and the 125 registered vacation rental units would see a \$13,321 increase (Eagle, August 26, 2008).

<sup>21</sup> Commercial businesses (e.g. retail stores) can expect a 12 percent decrease in property taxes while industrial businesses can see a 10 percent drop in taxes. Overall, the “general” category could see an increase in property taxes of 4.7 percent.

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<sup>22</sup> But the councilman who introduced the two percent cap in 2005 indicated that it was time to repeal the measure due to its inequity (Eagle, August 19, 2008, p. A5).

<sup>23</sup> Fujii, Im and Mak (1992). Maui island residents were also successful in defeating the State Department of Transportation's plan to extend their island's airport runway (Blackford, 2001, p. 190).

<sup>24</sup> Tizon (2007). An extensive coverage of this controversy, including a time line beginning in 2004, can be found in the October 10, 2007 issue of the *Honolulu Advertiser*.