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

By SALLY KWAK* and JAMES MAK**

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. Beginning in 1965 Hawaii experimented with a statewide split-rate property tax system to encourage economic growth and effect land reform. The experiment was ended in 1977. Following the transfer of property taxing powers to the counties in 1978, some counties brought back the split-rate property tax at times. Since 2006, Kauai County has adopted the unusual practice of taxing improvements at a higher rate than land for most property classes. This article chronicles and explains the rationale behind Hawaii's state and county experiments with split-rate property taxation.

Introduction

Nobel laureate in economics William Vickrey once observed that "The property tax is, economically speaking, a combination of one of the

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worst taxes—the part that is assessed on real estate improvements . . . and one of the best taxes—the tax on land or site value.”¹ 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, 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). Typically, the tax rate on the value of the land is set higher than that on improvements.² Around the world, more than 700 cities use the split-rate property tax system (Cohen and Coughlin 2005: 359). In the U.S. the split-rate property tax is currently employed only in 16 Pennsylvania municipalities and two counties in Hawaii. However, economists favor greater usage of split-rate property taxation by local U.S. jurisdictions. Dye and England (2009: 10) argue that “economic theory and, to a lesser degree, empirical evidence support the claim that taxing land values instead of wages, profits, or capital values would improve economic performance and could improve people’s lives.”

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, the split-rate system is able to achieve these objectives while remaining revenue neutral and minimizing excess burden (Dye and England 2009; Cohen and Coughlin 2005). There is a growing volume of empirical evidence to support the theoretical predictions (see, for example, Banzhaf and Lavery, in print; Dye and England 2009; Plassmann and Tideman 2000; Oates and Schwab 1997; and Shoup 1978) with more work in progress, notably, at the Lincoln Institute of Land Policy in Cambridge, Massachusetts.

However, the split-rate property tax is not without potential problems (Bourassa 2009). Redistribution of the property tax burden following tax reform could arouse political opposition to the change as the burden of higher tax rates on land (relative to improvement) values tends to fall more heavily on owners of properties with higher land to building values (Dye and England 2009; Chapman and Facer

II 2005; England 2004; Shoup 1978). A land value tax can be regressive for many homeowners (England and Zhao 2005; Bowman and Bell 2008).³

Inaccurate property assessments can also undermine the confidence of residents in supporting property tax reform. In 2009, a task force in Philadelphia reviewing the city's property tax system did not recommend the split-rate property tax in part because of distrust in the assessment system.⁴ Accurate assessment of land values separately from improvement (building) values is necessary in a split-rate property tax system but remains a challenge in implementation (Bell, Bowman, and German 2009; Bowman and Bell 2008; England and Zhao 2005). Brunori and Carr (2002: 2) find that 29 states require land and improvements to be valued separately for property tax purposes.⁵ Of the 244 local government offices that were charged with administering the local property taxes in these jurisdictions, 86 percent employed some form of comparable sales method, generally examining the sale of comparable vacant or unimproved land. A study conducted by the U.S. Advisory Commission on Intergovernmental Relations (ACIR 1989: 258) of property tax assessment methods employed in Hawaii concluded that Hawaii's approach of separating land values from improvement values "overstate[s] the value of land" because assessors "are required to use the cost approach to value improvements."⁶ This method calculates the land value component of a parcel as a residual by subtracting the depreciated improvement value from the value of the total parcel. The method is frequently used in urban areas that lack sufficient number of land sales to allow comparable sales analysis. Bell, Bowman, and German (2009: 173–174) describe potential problems that can undermine accurate assessment.

Dye and England (2009) compile a collection of essays that examine the theory, empirical evidence, and practices in land value taxation. This article contributes to this literature by examining the political economy of Hawaii's experience with split-rate property taxation, beginning in the 1960s and ending with the 2006 adoption of the unusual inverted split-rate property tax on Kauai.⁷ Hawaii is one of only two states that have experimented with split-rate property taxation. However, its experience has not yet been carefully documented.

Hawaii's experiment with split-rate property taxation is different from that of Pennsylvania because it was initiated at the state level and applied to the entire state. As in other localities where split-rate taxation has been adopted, Hawaii's legislation, passed in 1963 and repealed in 1977, stipulated higher tax rates on land than on improvements. In 1978, the state transferred the power to levy property taxes to the four counties. By fiscal year 1982, all four counties levied a uniform rate (within each county) on land and improvements. Subsequently, counties individually readopted the split-rate property tax on some property types over varying times. In an unusual move, Honolulu County (1989–1998) and Kauai County (2006 to the present) adopted the unusual practice of taxing improvements at a higher rate than on land on some properties resulting in an “inverted” split-rate property tax. In FY 2009, Hawaii County brought back the split-rate property tax but applied it to only two of ten property types, (non-owner occupied) “residential” and “agricultural or native forest” properties.

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 and the re-adoption of the split-rate property tax in some counties at various times. 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. Section V concludes.

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 the initial discussion of the Pittsburgh Tax Law, the Attorney General's office pointed out that land without a need for extensive improvements, such as agricultural land and conservation land, would be disproportionately burdened by the passage of the bill (Hawaii State Archives, Correspondence of the Attorney General). The Legislature passed legislation (Hawaii Revised Statutes Section 8 HRS 248-2) requiring a single rate to be applied to agricultural and conservation properties. Rates were phased in according to a graded schedule. Over time, the law increased the difference in rates on land and on improvements until the repeal of the Pittsburgh plan in 1977 (Tax Foundation of Hawaii various years).⁸

Hawaii's split-rate property tax was initiated by the state government due to the highly centralized state and local government system in Hawaii. Until 1978, the state controlled the property tax. Hawaii 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. Following statehood, the islands were divided politically into four counties: Honolulu, Maui, Kauai, and Hawaii (the Big Island); there are no lower levels of government with taxing powers. Hawaii's highly centralized form of government today is believed to be a legacy of the monarchy (Meller 1992).⁹

The high degree of centralization in Hawaii's system of state and local government also explains 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 government provides much of the expenditures on welfare, health, and hospitals. One government-funded analysis of the fiscal system concluded that "Compared to other states, Hawaii is fiscally centralized, with state government playing the dominant role. The degree of

centralization has increased over time” (Tax Review Commission 1984).

Throughout the 1960s and 1970s, Hawaii’s state and local governments administered 16 tax laws. Of these, 14 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 statewide split-rate property tax system.

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 the county governments.¹⁰ However, with the major expenditure responsibilities—in particular, public school funding—still reserved to the state government, property tax rates remained low in comparison to rates in U.S. mainland states and cities. Using FHA mortgage data, the U.S. Advisory Commission on Intergovernmental Relations (ACIR 1989: 243–244) estimated that:

... in 1966, Hawaii’s effective property tax rate was 0.81 percent of market value, again well below the national average, which at the time was 1.70 percent. Only four states had a lower effective property tax rate in 1966 than Hawaii (Alabama, Louisiana, South Carolina, and West Virginia).

In 1966 the effective property tax rate in Hawaii was only 48 percent of the national average. The ACIR (1989: 243–244) further noted that “between 1966 and 1986, the effective property tax rate fell faster in Hawaii than in the U.S. as a whole.”

There are two aspects of Hawaii’s history and background characteristics that contributed to the passage and implementation of the split-rate property tax. First, the 1960s were years of rapid growth in Hawaii’s economy driven largely by tourism (Mak 2008: Chapters 2 and 3; Hitch 1992). In 1959 average income per person in Hawaii was 20 percent below the national average (Mak 2008: 30). Political historian, Tom Coffman (2003: 167) notes that “. . . rapid economic growth was a powerful companion to the Democratic Party’s goal of developing a politically progressive, multiracial society.” Split-rate

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

The second crucial factor in Hawaii's passage and implementation of the split-rate system was political. The Democrats gained ascendancy in a great electoral victory in 1954 against a backdrop of decades of past Republican rule. The power base of the Republican Party was the Big Five, the consortium of five sugar factors that held most of the economic power and wealth in the islands. The first part of the 20th century saw a high concentration of wealth, land ownership, and power in the hands of the Republicans. Before World War II, almost half of all the total land area of the Hawaiian islands was held by fewer than 80 private individuals; the rest was largely publicly owned. Most the agricultural land was also owned by the same private individuals (Cooper and Daws 1985: 3). 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). Cooper and Daws (1985: 2) note that land in Hawaii "has always been a political battleground and prize."¹¹

In contrast to the mainly Caucasian dominated Republican Party, the Democratic Party was multi-ethnic and consisted of many Asian immigrants and their children.¹² They came into office promising land and tax reform (Cooper and Daws 1985: 37). 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: 5). Shoup (1978: 119) argues that Hawaii's high concentration of land ownership made it politically feasible to adopt the split-rate tax system; there were few landowners who might lose by the switch while there were many more people who would gain.

The Democrats' platform consisted of three main proposals, one of which was the Pittsburgh Tax Bill. In passing this bill (1963), the Democrats "intended to stimulate construction" by levying a lower property tax rate on assessed building values than on land values (Cooper and Daws 1985: 37). Another intended effect of the Pittsburgh

plan was to persuade large landowners to develop their land or to sell it to someone else who would use it (Cooper and Daws 1985: 37). 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.¹³ This political change combined with the unique history of land and power in Hawaii contributed to the eventual implementation of split-rate property taxation.

Table 1 shows that agricultural and conservation lands were not included in the newly installed split-rate property tax system in 1965. The arrival of the split-rate system in Hawaii was accompanied by higher average property tax rates in all four counties. In 1963, the statewide average rate was \$14.75 per \$1,000 net taxable property. In 1965, the average rate rose to \$17.54 per \$1,000 net taxable property; the rate on land was \$3.42 cents per \$1,000 net taxable property higher than before the reform while the rate on buildings was \$1.58 higher.

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 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 Plan survived for 14 years. It was eventually repealed as residents' appetite for growth waned in the 1970s (Mak 2008: Chapter 3). By 1970, per capita personal income in Hawaii exceeded the national average by nearly 25 percent (State of Hawaii Department of Business, Economic Development, and Tourism 2006: Table 13.07.) The advent of statehood in 1959, introduction of jet travel to Hawaii that same year, and the liberalization of outbound tourist travel by Japan, and the robust growth of the U.S. and Japanese economies had quadrupled tourism in a decade, bringing with it large

Table 1
 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).

increases in demand for hotel and tourism-related construction and workers. With the local labor force unable to fill this demand, immigrants filled the labor gap, fueling growing resident discontent and anti-growth sentiments (Mak 2008: Chapter 3).¹⁴ 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.”¹⁵ In the mid-1970s, the state embarked on a massive effort to develop the nation’s first comprehensive state development plan (The State Plan) to address perceived problems stemming from economic growth.¹⁶ Bourassa (2009: 197) surmises that land value taxation was abolished in Hawaii because “a high rate of development led to a perception that the tax was too effective and therefore undesirable.”

The state also experienced significant problems with implementation following passage of the Pittsburgh Tax Plan in 1963. The plan was considered to be overly complicated, opaque, and inequitable. The *Honolulu Star Bulletin* published articles in 1963 and 1964 reporting on the excessive complexity of the bill.¹⁷ The State Tax Director wondered how his office would explain the complex bill to taxpayers. The executive director of the Tax Foundation of Hawaii opined that the complexity of the bill would increase tax collection costs. In December 1963, the State Tax Department noted that the proposed bill would be unfair to owners of homes built on fee simple land versus homes built on leasehold land. The overall tax on fee simple properties would increase because a higher proportion of their total values was in land while a higher proportion of a leasehold’s property was in the building value. The Tax Director asked the Legislature to rectify the mistake as this was not the Legislature’s intent.¹⁸ The Honolulu Chamber of Commerce called for the repeal of the Pittsburgh Plan in 1964 even before the law went into effect. In 1977, opponents of the split-rate structure won and the Legislature repealed the split-rate system, re-instituting and phasing in a single-rate system.¹⁹

Return of the Split-Rate Property Tax at the County Level

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.²⁰ 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. Average tax rates varied among the four counties. However, by FY 1999, three of the four counties—Hawaii, Honolulu, and Kauai—had reinstated some form of the split-rate property taxation. Maui County alone elected to retain a single-rate structure.²¹

Hawaii County

Between FY 1983 and FY 2002 Hawaii County imposed a higher tax rate—approximately 20 percent more—on land for all property types except improved residential and homeowner properties.²² Afterwards, the county adopted a single-rate structure for all properties until FY 2009. In FY 2009, Hawaii County brought back the split-rate property tax but applied it only to two of ten property types, (non-owner occupied) “residential” and “agricultural or native forest” properties. The new rates were (and remain currently at) 14 percent higher on land on “residential” properties but 31.5 percent higher on “agricultural or native forests” (City and County of Honolulu, Real Property Assessment Division July 29, 2008). This was achieved by keeping the tax rates on land unchanged while reducing the tax rate by \$1 per \$1,000 of net taxable assessed valuation on improvements on (non-owner occupied) single family residences (from \$8.10 to \$7.10) and \$2 per \$1,000 of net taxable assessed valuation on improvements on agricultural or native forest lands (from \$8.35 to \$6.35). The reduction in property tax rates on improvements in these two property classifications was to enact tax relief due to large increases in assessed valuations for FY 2009 (Quirk 2008b, 2008c). Assessed values on residential improvements increased by 63 percent between FY 2008 and FY 2009 and 59 percent on “agricultural and native forest” improvements. By comparison, all other property classifications saw assessed improvement values increase by an average of 11.5 percent between the two years. In public hearings, the most vocal complaints were directed at the sharp increase in agricultural improvement assessments.²³ Between FY 2008 and FY 2009, the gross assessed value of agricultural and native forest lands in the county fell slightly from

\$4.67 billion to \$4.47 billion while the gross value of improvements on that land increased from \$1.69 billion to \$2.69 billion. The increase in the assessed value of improvements was not because there were more properties to tax; indeed the number of records for agricultural/native forest properties actually decreased slightly from 69,426 in FY 2008 to 68,913 in FY 2009. By law, the county is required to assess properties at 100 percent of their market values. However, according to the Hawaii County Real Property Tax Administrator, assessment of improvements had fallen badly behind (Quirk 2008a). Working in cooperation with the City and County of Honolulu, Hawaii County conducted engineering studies that resulted in the adjustment of the cost tables used to determine building assessments, bringing building assessment values in FY 2009 up to 90 percent of market values from 75 percent. Thus, the big jump in assessed building values was a catch-up to market valuation. The Property Tax Administrator explained that land assessments were adjusted a few years ago and hence would remain stable between FY 2008 and FY 2009. Owners of agricultural properties who resided on their land lobbied for tax relief, noting that homeowners who live in their own homes received preferential tax treatment from the county's 3 percent cap on annual increases in their property tax assessments. The County Council and the Mayor were in agreement on the need for rate cuts (Quirk 2008c). The new rates were estimated to save taxpayers nearly \$7 million in annual property tax payments (Quirk 2008c).

Honolulu County

Honolulu County implemented a single-rate structure, except during a 10-year period between FY 1989 and FY 1998. During this period, the county set higher rates on buildings than on improved residential properties (see Table 2).²⁴ 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 2 shows that rates on both land and buildings fell during the early '90s. This followed rising housing prices on Oahu 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

Table 2
 Property Tax Rates on Improved Residential Properties in Honolulu
 FY 1989–FY 1999 (\$ 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.realproperty.honolulu.com/portal/rpadcms/Reports?parent=REPORTS&code=-1>.

1989: 239). The run-up in real estate prices was widely attributed to speculative Japanese real estate investments.²⁵ 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.²⁶ 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 purchased 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.²⁷ Between FY 1984 and FY 2005 land for all property classes was taxed at a higher rate than on improvements. However, beginning in FY 2006, 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 3 compares the structure of property tax rates by county land use classes on Kauai for FY 2006 and FY 2005.

The inverted structure of Kauai’s 2006 implementation of split-rate property taxation for five of the eight property classes is, at first glance, puzzling. In the following section, we examine the reasons for its adoption.

Table 3

Property Tax Rates in Kauai County: FY 2006 vs FY 2005 (\$ per \$1,000 net taxable property)

Land Use Class	Land		Buildings		Buildings/Land	
	2006	2005	2006	2005	2006	2005
Single family residential	\$4.00	\$5.14	\$4.30	\$4.30	1.08	0.84
Apartment	6.95	8.20	7.95	7.95	1.14	0.97
Commercial	6.95	8.20	7.95	7.95	1.14	0.97
Industrial	6.95	8.20	7.95	7.95	1.14	0.97
Hotel and Resort	6.95	8.20	7.95	7.95	1.14	0.97
Agricultural	6.95	7.60	4.30	4.30	0.62	0.57
Conservation	6.95	8.10	4.30	4.30	0.62	0.53
Homestead	4.00	4.00	3.44	3.44	0.86	0.86

Notes: 1. Apartment includes non-owner occupied units in multi-unit residential buildings, condos, and timeshares.

2. Homestead properties are used as owners' principal residences.

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

Kauai's Inverted Split-Rate Property Tax Structure

Beginning in late 1998, property values jumped sharply on Kauai (Youn 2003; Scontras 2009). Table 4 shows that residential property tax assessments rose rapidly after 2000.

The U.S. Advisory Commission on Intergovernmental Relations (ACIR 1989: 239) has observed that historically in Hawaii, "property values have tended to increase more rapidly than incomes." 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 to cap annual assessment increases on owner occupied homes. The vote was invalidated by the Hawaii Supreme Court in 2007 (Zimmerman 2007; Supreme Court of Hawaii 2007). The county also established a nine-member Real Property Tax Task Force whose mission was "to create a tax model which provides predictability, equity, and clarity."²⁸ The Task Force met in over 28 meetings and in October 2004 unveiled a series of specific recommendations. It sug-

Table 4

Gross Assessed Property Tax Values for Residences, Kauai
County FY 1993–FY 2009
(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/>.

gested 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 that 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 \$1,000 in assessed value. On “General” properties, the tax rate would be \$4 for land and \$12 for buildings for every \$1,000 in assessed value. In sum, buildings would be taxed at rates three times that of 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). Instead, the County Council enacted a temporary fix, capping annual property tax bill increases on homes owned and occupied by residents at 2 percent, and 6 percent for residents who put their second homes into long-term rentals (Eagle 2008). The mayor further proposed and the Council reduced tax rates on land for

all properties except for homesteads.²⁹ In a news release, the mayor explained, "I now believe that it is absolutely necessary to provide immediate tax relief to offset escalating property values across the remaining tax classifications."³⁰ Table 3 shows that this was achieved by cutting the tax rate on land on all property types, except on homesteads, and keeping the tax rate on buildings unchanged. This resulted in a split-rate property tax structure that imposed slightly higher tax rates on buildings than on land for residential, commercial, hotel/resort, and industrial properties.

Table 5 shows estimated (and hypothetical) tax savings due to the reductions in land tax rates alone by applying rate cuts to gross land assessments in FY 2006. Table 5 also presents the building to land value ratios for all eight county property classes. Overall, cuts in tax rates on land alone saved taxpayers almost \$7 million, or nearly 8 percent of the projected annual tax bill and, as the mayor desired, every land use class except "homesteads" benefited from the rate cuts.³¹ However, not all property types received the same degree of tax relief. Hotels/resorts and apartments (which include non-owner occupied condominium units and timeshares), which have the highest building to land value ratios, benefited the least (3.6 percent and 4.4 percent, respectively) while single family residences benefited the most (17.2 percent). While shifting tax shares to tourism and visitors may have been in the minds of the mayor and councilmen when the new rates were set, the primary motive for the tax rate cuts on land in 2006 was to provide property tax relief to all property owners, not just to people who live in their own homes. Thus, the inverted property tax structure was not some grand scheme to influence capital investment and land use decisions.³²

Conclusion

The property tax is widely considered to be a stable and reliable source of tax revenue to fund public services. In this article, we document that it can also be used as a political instrument to promote economic and social change, punish undesirable investors, and provide tax relief to local taxpayers at the expense of non-residents.

In the 1960s, Hawaii lawmakers adopted a statewide split-rate property tax system in which land was taxed at a higher rate than

Table 5
 Kauai Property Tax Savings Due to Reductions in Land Tax Rates (FY 2006)

Land Use Class	Gross		Property Taxes at ¹		Savings at ²		Savings in	
	Bldg/Land Value		FY 2005 Rates		FY 2006 Rates		Percent (%)	
Single Family	0.348		\$20,102,226		\$3,452,434		17.2%	
Apartment	2.529		12,827,424		5,66,416		4.4	
Commercial	0.695		8,462,430		770,893		9.1	
Industrial	0.725		2,518,115		225,465		9.0	
Agricultural	0.256		13,671,664		1,021,188		7.5	
Conservation	0.099		3,190,965		297,027		9.3	
Hotel & Resort	2.837		14,741,964		530,634		3.6	
Homestead	0.714		16,780,598		0		0	
			\$89,423,576		\$6,864,057		7.6%	

Notes: (1) Calculated by multiplying 2006 gross assessed valuations for land and buildings, separately, by their respective 2005 property tax rates from Table 3.

(2) Savings are the difference between tax liabilities at FY 2006 rates and tax liabilities at FY 2005 rates, both using gross assessed valuations in the calculations.

(3) "Apartment" includes non-owner occupied units in multi-unit residential buildings, condos, and timeshares.

(4) "Homestead" properties are used as owners' principal residences.

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

improvements. This policy satisfied political goals of the period: namely, to promote economic growth and effect land reform. Whether tax reform accelerated economic growth remains empirically untested. Fourteen years later, the plan was repealed when high rates of economic growth became politically less desirable.

Following its transfer to the counties, the split-rate property tax was re-introduced at different times by three of the four counties. In the late 1980s, Honolulu County adopted the highly unusual practice of taxing improvements at a higher rate than land to punish foreign investors who were blamed for driving up housing prices in Honolulu.

Currently two counties—Kauai and Hawaii—apply the split-rate property tax to some property types to provide tax relief to mitigate the effects of sharply rising property values. One taxes land at higher rates than improvements; the other taxes improvements at higher rates than land. We are unable to draw empirically tested conclusions about the effects of these policies on economic growth. However, in all three cases, politics play a significant role in the passage and implementation of split-rate reforms.

Notes

1. Quote from Cohen and Coughlin (2005: 359).

2. Pittsburgh, along with a few smaller cities in Pennsylvania, has had a graded property tax system since 1913 under which land was taxed at twice the rate of improvements until 1979. In 1979 and 1980, the city of Pittsburgh restructured its property tax system so that land in the city was taxed more than five times the rate on structures. Since the county and the overlying school district also levied property taxes and they did not participate in the graded property tax system, the actual rate differential after 1979 resulted in land in the city being taxed at somewhat more than twice the value of improvements. Properties outside the city remained under the conventional property tax system (Oates and Schwab 1997: 6–8). Tax reform in Pittsburgh raised the tax rate on land and effectively reduced the rate on improvements on new structures (Oates and Schwab 1997: 8). In 2001 Pittsburgh ended its split-rate property tax system. A combination of downward inflexibility in tax rates and a subsequent increase in tax burden led to the end of land value taxation in Pittsburgh (Dye and England 2009).

3. They also suggest that regressivity can be mitigated by a tax credit on property tax bills.

4. At <http://urbantools.org/news/philadelphia-task-force-on-tax-reform-one-step-short>.

5. HRS Sections 246–10, 246–43 require land and improvements to be assessed separately in Hawaii (Brunori and Carr 2002: 11).

6. The ACIR did not provide an estimate of the upward bias. Bowman and Bell (2004) note that Roanoke, Va. also uses the abstraction method.

7. Hawaii does not impose a property tax on personal property.

8. For example, in Honolulu County, land under commercial properties was taxed at 11 percent higher than improvements in 1965; the gap widened to 25 percent by 1971; and to 43 percent in 1977 when the law was abolished (Tax Foundation of Hawaii various years).

9. 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 the other islands combined, Oahu is by far the most populous.

10. Article VIII, Section 3 of the Hawaii State Constitution. See Lee (1993: 143–144).

11. Also Daws (1968: 395).

12. In 1960, Japanese (203,000), Filipinos (69,000), and Chinese (38,000) comprised nearly half of the state’s resident population. (Nordyke 1989).

13. The State 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: 81–82; LaCroix, Mak, and Rose 1995; Mak 1992). The law was highly controversial and challenges made their way to the Hawaii and U.S. Supreme Courts over its public purpose, which were decided in the homeowners’ favor. Cooper and Daws (1985: 5–6) also noted that the Democrats made changes to land use laws in the 1950s and 1960s that “cut away at the virtually unrestricted power of the old major landowners . . .” On the other hand, they opined (1985: 38) that the tax changes on the whole were “rather modest.”

14. Between 1960 and 1970 there was a net migration of 50,000 people into Hawaii, excluding military movements (Gardner and Nordyke 1974: 29). This accounted for slightly less than 40 percent of the increase in the resident population between the two years.

15. Coffman (2003: 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.

16. Mak (2008: Chapter 8).

17. For a list of these stories, see the Index to the *Honolulu Advertiser* and *Honolulu Star Bulletin* 1929–1967 (1968) under the subject headings “Land” and “Property Taxes”; of particular interest are the following *Honolulu Star Bulletin* stories on April 5, 1963; April 10, 1963; December 5, 1963; February 20, 1964 as well as the *Honolulu Star Bulletin/Advertiser* story on March 17, 1963.

18. LaCroix, Mak, and Rose (1995: 999–1000) report that in 1967 single family homes on leasehold land comprised about 26 percent of the total stock of single family homes, most of them were located in Honolulu County. In the mid-1960s condominiums began to be developed some on leasehold land. While (comparable) homes built on leasehold land sold at lower prices than homes built on fee simple land (Fry and Mak 1984), for property tax purposes, leasehold land in Hawaii is currently assessed as fee simple property with tax bills sent to homeowners (lessees) rather than to landowners (lessors) (Revised Ordinances of Honolulu, Chapter 8, Sec. 8-6.3.). According to Robert Magota (personal telephone conversation on November 18, 2009) of the Honolulu County Real Property Tax Assessment Division, this method of assessment is common practice in other U.S. localities where there is leasehold residential housing. In theory, this implies that the higher effective land tax on leasehold properties should result in a lower market price for a leasehold property vis-à-vis an identical fee simple property.

19. *The Honolulu Star Bulletin* ran a story on June 3, 1977 (p. A6) with the caption, “Property tax law intended to foster development is repealed.”

20. 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.”

21. As the fastest growing county in Hawaii, Maui did not appear to need further fiscal incentive to spur development. See ACIR (1989) and Mak (2008: Chapter 8).

22. In FY 1983, land under single family residential land was also taxed at a higher rate than buildings. Between FY 1985 and FY 2002, the land tax rate was held constant at \$10.00 per \$1,000 of net taxable property while buildings were taxed at \$8.50.

23. It was noted in public hearings that West Hawaii would be particularly hit hard by the new assessments on residential property improvements because the area has many non-resident (second) homeowners who do not qualify for tax relief under the homeowner category (Quirk 2008c).

24. Higher rates on buildings also applied to apartments but only between FY 1989 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>.

25. Others have pointed the finger at supply constraints. The U.S. Advisory Commission on Intergovernmental Relations (ACIR 1989: 239) argued that supply side pressures were likely more important than demand considerations, noting that growth in the housing stock did not keep pace with rising population.

26. Personal conversation with Lowell Kalapa. The idea to raise property taxes on homes combined with a tax credit to rebate increases to resident homeowners was one suggested remedy for unaffordable housing in Hawaii during the early 1990s. Ordway (1993: 128).

27. For instance, Coffman and Noy (2009) found that Kauai's economy did not recover from Hurricane Iniki until seven to eight years after the storm, and its population and labor force still have not fully recovered 17 years after the storm.

28. See http://www.kauai.gov/Portals/0/Finance_RP/RPT_update_041015.pdf.

29. Recall that homesteaders had a 2 percent cap placed on their property tax bills.

30. At http://www.kauai.gov/Portals/0/Mayor/PIO/PR_Archives/2005/NR05-06-05%20_Mayor%20seeks%20largest%20tax%20rate%20reduction%20in%20island%20history_.pdf.

31. Actual tax bills are calculated using net assessed valuations; net valuations subtract out exemptions. In Table 5 we wanted to show the approximately property tax savings due to the cuts in tax rates on land values alone. Actual tax bills also include revenues lost due to successful appeals.

32. Another bill introduced in 2008 (Bill 2274) that would have targeted tourism for heavier taxation did not pass. See Kato, Kwak, and Mak (2010).

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