

# Public Policy

## Creating a Fairer State Tax System and Economy for All Families

### EXECUTIVE SUMMARY

**I**N HAWAII AND ACROSS THE NATION, more people are relegated to poverty while our moderate-income families are struggling more than ever. Our state has drifted from its longtime commitment to economic justice for all families, while income inequality has grown.<sup>1</sup> An increasing reliance on regressive taxation for state revenue comes at great expense to our low-income households, especially those in poverty. We have failed to adjust our tax system to account for harsh economic realities and allowed the value of the minimum wage to decline dramatically. While the consequences of these policies hit low-income households the hardest, poverty weakens the social fabric of our community and affects all of us. Supporting our low and moderate-income families is critical to the well-being of our people and strength of our economy.

Hawaii's infamous "price of paradise" makes meeting day-to-day needs a constant struggle for low and moderate-income residents. Hawaii has the highest cost of living in the country:<sup>2</sup>

- Food costs for a family of four are 68 percent more than what they are on the mainland.<sup>3</sup>
- Hawaii has the highest cost of shelter in the nation; with almost three-quarters of extremely low-income people spending more than half of their income on housing.<sup>4</sup>
- Electricity and gas prices are the highest in the country.
- In large part due to the high cost of basic necessities, Hawaii has been consistently ranked as the worst state to earn a living.<sup>5</sup>

Yet the economic challenges facing low-income households are not limited to the cost of living. The regressive structure of Hawaii's tax system makes it even harder for families to make ends meet:

- The bottom 40 percent of households in Hawaii pay almost 13 percent of their income in state and local taxes, while the top 1 percent pay around 8 percent.
- Hawaii is one of only fifteen states that tax the income of residents living in poverty.
- Hawaii's General Excise Tax (GET) is effectively one of the highest statewide sales tax rates in the nation. Because the GET applies

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to nearly all goods and services, the tax burden of the GET falls most heavily on our lowest-income households who must spend a larger share of their income on basic necessities, most of which are taxed at the full GET rate.

- Credits intended to reduce the disproportionate share of taxes paid by low and moderate-income households have not been updated for years, even decades. The imbalance grows greater each year as inflation and the cost of living increase and the credits stay the same. One such credit, the low-income household renters credit, is worth less than 40 percent of its original value based on inflation alone.

Given these features of Hawai'i's tax system, our residents living in poverty pay a greater share of their income in state taxes than those in all but three other states.<sup>6</sup> The highest cost of living in the nation, and one of the most oppressive and regressive tax structures, combine to form a nearly inescapable prison of poverty. Hawai'i's minimum wage only makes matters worse—it is lower than 19 other states and the District of Columbia, all of which have significantly lower costs of living, and it has not been updated for more than six years to keep up with inflation or wage increases of higher-income earners. It is time for Hawai'i to take action and reduce inequity in our community by using economic policy to help working families.

To this end, Hawai'i should make five policy changes that will make a significant difference in the economic well being of low and moderate-income workers:

- 1 Adjust the food/excise credit for inflation over the past 6 years
- 2 Adjust the low-income household renters credit for inflation over the past 30+ years
- 3 End income taxation of low-income workers living below or near the poverty line
- 4 Create a state earned income tax credit
- 5 Increase the minimum wage

While some of these proposals will diminish the state's tax collections, this report suggests a number of options which would generate significant new revenues for Hawai'i. Many of these proposals would also help make the tax system more equitable by ensuring everyone pays their fair share, for example, by eliminating tax breaks for capital gains income. The total cost of the low and moderate-income tax relief proposals would be \$77 million, while the proposed revenue-generating measures would raise \$689.9 million for the state—covering this tax relief many times over. Simply collecting taxes from online and mail order purchases—which are already owed, but not remitted—would generate as much as \$183.3 million in additional revenue.

The cost to our community and families, as well as the expensive social services needed to help families struggling to survive, is far too high for Hawai'i to bear. We have a moral obligation to Hawai'i's families to take decisive action and return to our state's progressive heritage of community responsibility, equal opportunity, and fairness. Adopting these recommended economic policy proposals will guide us back to a time of shared prosperity.

## HAWAI‘I’S SHIFT TO REGRESSIVE TAXATION

Sales and excise taxes are the most regressive form of taxation. Unlike wealthier households who can save or invest their income, lower-income households must spend all or most of their income on necessities such as food, shelter, and transportation. As a result, low and moderate-income residents end up taxed on a far greater percentage of their income than higher-income households. Meanwhile, wealthier households that are able to invest or purchase a home receive additional tax benefits unavailable to families who must expend all or most of their income to survive.

Hawai‘i relies heavily on regressive taxation of consumers for state revenues. But Hawai‘i’s tax system goes far beyond a conventional sales tax. Unlike most states that levy a one-time sales tax on final consumer goods, Hawai‘i relies on a General Excise Tax (GET) imposed on gross business receipts for almost every kind of transaction. The initial goal of this atypical tax structure was to raise revenue via a broad-based tax on consumption after the reduction of real property tax rates and elimination of personal property taxes in the 1930s.<sup>7</sup> Initially set at 1.25 percent for the general public, the GET has gradually increased and been modified as Hawai‘i’s economic profile has evolved.<sup>8</sup> Today, the GET is set at 4 percent statewide for nearly all consumer goods and services, with a 0.5 percent county surcharge on Oahu.<sup>9</sup> Agricultural production, manufacturing, and wholesalers pay a significantly reduced GET rate of 0.5 percent.<sup>10</sup> In addition to tangible goods, the GET is levied on nearly all services, including essentials such as doctors’ visits or childcare.<sup>11</sup> While many states provide exemptions, exclusions, or reduced tax rates for necessities such as groceries or health care services, in Hawai‘i virtually all consumer goods and services are fully taxed at the regular rate.<sup>12</sup>

The GET has been highly successful at generating revenue by distributing the tax burden across an extremely broad base of goods and services. While Hawai‘i’s GET has one of the lowest statutory rates in the nation, it has the broadest base,<sup>13</sup> with 160 out of 168 services, and virtually all goods subject to sales taxes.<sup>14</sup> The GET is the largest source of revenue for the state, generating approximately half of the state’s income.<sup>15</sup>

Unfortunately, the GET’s success as a revenue-raising measure comes at a significant social cost. The GET results in a highly regressive tax system, with the tax burden falling most heavily on our lowest-income households. According to the Institute on Taxation and Economic Policy, the bottom 40 percent of households in Hawai‘i pay almost 13 percent of their income in state and local taxes, while the top 1 percent pay around 8 percent.<sup>16</sup> Compounding the highly regressive effect of the GET is a system in which many of Hawai‘i’s low-income residents, including some living below the poverty guidelines, actually have state income tax liability. These and other factors led the Institute to rank Hawai‘i as fourth worst in the country for taxing its residents living in poverty.<sup>17</sup>

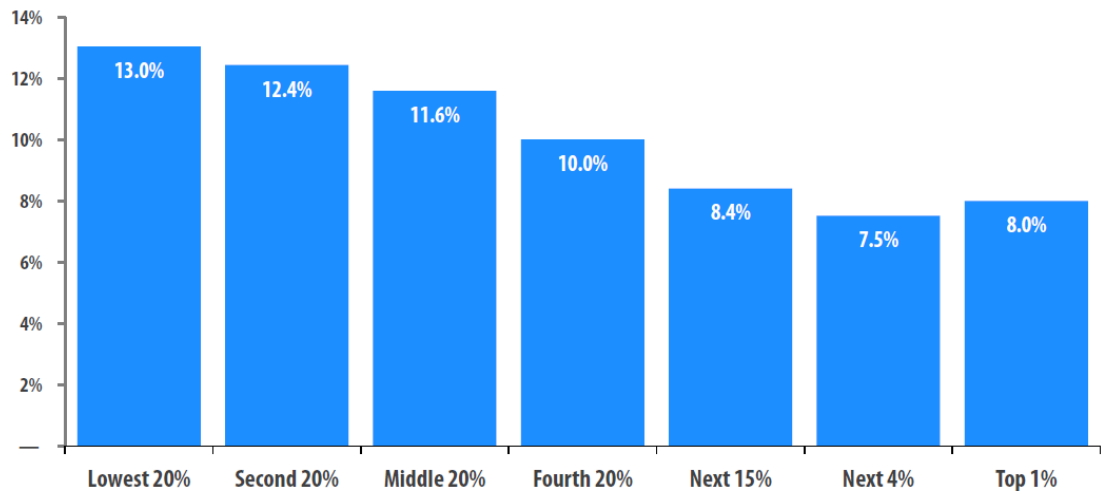
The structure of Hawai‘i’s GET plays a major role in the regressivity of our state tax system. While our statewide rate of 4 percent is one of the lowest in the nation,<sup>18</sup> our tax structure hides most of what residents actually pay. Because the GET is levied at several points along the supply chain—at production, wholesale, retail, and purchase—we actually pay taxes well over the 4 percent rate visible at the point of final sale. Taxing goods multiple times results in tax “pyramiding” and increases the cost to consumers. As a result of this pyramiding, Hawai‘i residents have been estimated to pay an effective statewide sales tax rate of around 11 percent.<sup>19</sup> Instead of having one of the lowest statewide sales tax rates, Hawai‘i actually has the highest statewide taxes on general goods and services: residents of only three cities in the entire nation pay a higher rate.<sup>20</sup> Because lower-income families

must spend a larger share of their income on basic necessities, this 11 percent effective tax rate hits them hardest.

Even the GET itself is subject to pyramiding because it is a gross business receipts tax, which requires businesses to pay the full GET on the tax collected from consumers. Sellers are allowed to pass this cost on to the consumer, resulting in an effective tax rate of 4.712% in Honolulu and 4.166% in the rest of the counties.<sup>21</sup>

## Hawaii State & Local Taxes

Shares of family income for non-elderly taxpayers



Institute on Taxation and Economic Policy, *Who Pays?: A Distributional Analysis of the Tax System in all 50 States*

In response to the regressivity of Hawai'i's GET tax and the high cost of shelter, the state has created two refundable tax credits: a low-income household renters credit (LIHR) and a food/excise tax credit. Refundable credits reduce a filer's tax liability, and when the amount of the credit is larger than the amount of income tax that the filer owes, the filer will receive a refund in that amount from the state.

These credits are critical to reducing the disproportionate share of taxes paid by low and moderate-income households, but they have failed to keep pace with inflation, let alone the staggering cost of living in Hawai'i. Merely adjusting both existing credits for inflation would significantly improve tax equity.

# RECOMMENDATIONS TO RESTORE TAX EQUITY

Hawai'i's current tax system is in need of sensible reforms that (1) restore the intended values of the two existing tax credits aimed at helping low and moderate-income residents, (2) end current policies of taxing those living in poverty, and (3) support low and moderate-income workers in achieving financial security by implementing a state earned income tax credit (EITC) and raising the minimum wage. Together, these changes will make it more possible for thousands of wage earners and their families to earn enough to live productive, healthy, and successful lives in Hawaii.

## 1 ADJUST THE LOW-INCOME HOUSEHOLD RENTERS CREDIT

Even though renters do not own the property they reside in, they are affected by both county property taxes and the state GET. Owners pay property taxes on rental buildings, while the GET is levied on receipts from rentals. To maintain their profit margins, landlords pass these costs along to tenants. At the same time, renters don't benefit from the property tax home exemption granted to owner-occupied residences.

To provide tax relief for low-income households, the low-income household renters credit (LIHR) was created in 1977. The current credit value came into effect for tax year 1981, and the current eligibility cutoff (i.e., the amount a household can make and still receive the credit) took effect in tax year 1989. Presently, a qualified filer with a Hawai'i Adjusted Gross Income under \$30,000 who has spent at least \$1,000 on rent can receive a refundable tax credit of \$50 per qualified exemption. By adjusting the LIHR credit for inflation since 1981, tax filers with a *federal* AGI of \$59,700 would receive a \$146 per exemption credit.<sup>22</sup>

The current LIHR credit is worth less than 40 percent of its original value based on inflation alone. This adjustment does not take into account the dramatic increase in rent over the last few decades. Average rents in Hawai'i increased by 45 percent during 2005–2012, more than twice the rate of inflation during just that seven-year period.<sup>23</sup>

Low-Income Household Renters Credit:	
<b>1981 / 1989</b>	Eligibility cutoff: \$30,000 Amount of credit: \$50 per exemption
<b>Adjusted to 2014</b>	Eligibility cutoff: \$59,700 Amount of credit: \$146 per exemption
Source: Institute on Taxation and Economic Policy	

### Cost of Updating the Low-Income Household Renters Credit

Updating the Hawai'i Department of Taxation's most recent estimates<sup>24</sup> to account for growth in Hawai'i's population and income levels, we project that the LIHR currently provides about \$6 million in tax relief to low-income filers. Bringing its values in line with inflation as measured by the Consumer Price Index will provide an additional **\$23 million** in

tax relief to this population.<sup>25</sup> With these adjustments, the low-income household renters credit would benefit roughly 90,000 households.<sup>26</sup>

## 2 ADJUST THE FOOD/EXCISE TAX CREDIT

To alleviate the highly regressive effect of the GET, the refundable food/excise tax credit was established in 2007 to replace a then-existing “low-income refundable tax credit.”<sup>27</sup>

**Maintaining the Value of Tax Credits:** To keep current with economic conditions, tax credit amounts and eligibility criteria should be modified so that they automatically increase with inflation, just as many federal income tax credits and exemptions do. These changes will simplify our tax credit structure and ensure that the credits perform their intended purpose.

The food/excise credit has not been changed since it was established.<sup>28</sup> Currently, the food/excise tax credit is available to filers whose federal AGI is under \$50,000. Eligible filers receive a refundable credit per exemption that depends on their income level, with a maximum credit of \$85 per exemption for those with a federal AGI of less than \$5,000 per year.

Adjusting the food/excise tax credit for inflation since 2008, tax filers with a federal AGI of up to

\$56,500 would be eligible for a maximum \$96 credit per exemption.

### Cost of Adjusting the Food/Excise Tax Credit

Based upon the most recent numbers available from the Department of Taxation,<sup>29</sup> we estimate that the food/excise credit currently provides approximately \$29 million to low and moderate-income tax filers. Bringing its values in line with inflation will provide an additional **\$7.2 million** in tax relief to this population. These adjustments to the food/excise tax credit will benefit close to 354,000 households.

## 3 END HAWAII’S PRACTICE OF TAXING WORKERS FURTHER INTO POVERTY

Hawaii should create a new low-income worker credit (LIWC) to ensure that those who live below the federal poverty guidelines will have no state income tax liability. Hawaii is one of only fifteen states that tax the income of those living below the poverty guidelines. Low-income workers should not be driven deeper into poverty by the state through income taxes.

Poverty’s myriad negative effects on the well-being of individuals, families, children and communities are all too apparent. The impact of poverty includes hunger, homelessness, poor health, lost educational opportunities, higher crime rates, and reduced productivity. These consequences not only weaken our communities but result in increased public expenditures for the social services needed to remedy the problems arising from poverty. Taxing those who are in poverty makes it more likely that they will remain poor.

We recommend creating a low-income worker credit that eliminates the burden Hawaii state income taxes place upon wage-earners living in poverty. This can be done by creating a nonrefundable credit that will completely offset whatever income tax is still owed after a low-income filer has applied any applicable state credits. If a filer earns less than the



federal poverty guidelines and has applied all other available credits, the low-income worker credit would simply eliminate any remaining tax liability.

In order to avoid a steep tax cliff for those just above the federal poverty guidelines, we also recommend a non-refundable tax credit that offsets 50 percent of the end-of-year state income tax burden for those filers making 100–125 percent of the federal poverty guidelines.

Reductions in income tax revenue due to a LIWC can be limited by carefully designing the credit to benefit workers in greatest need.

Incomes of Households Benefiting from the LIWC		
Household size	Poverty level	125%
1	\$13,230	\$16,538
2	\$17,850	\$22,313
3	\$22,470	\$28,088
4	\$27,090	\$33,863
5	\$31,710	\$39,638
6	\$36,330	\$45,413
7	\$40,950	\$51,188
8	\$45,570	\$56,963

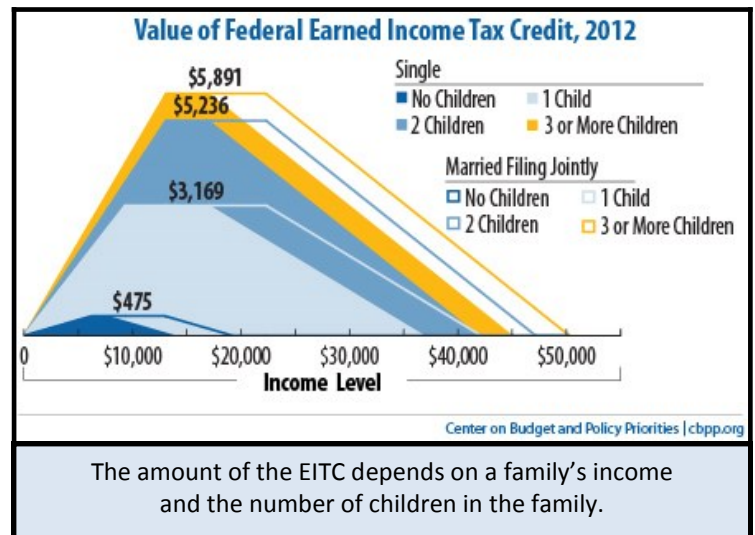
### Costs of the Low-Income Worker Credit

Based on estimates provided by the Hawai'i Department of Taxation in 2012, a tax credit that eliminates the end-of-year income tax burden on residents below 100 percent of the federal poverty guidelines will result in a reduction in reported liability of \$21.5 million.<sup>30</sup>

## 4 ADOPT A STATE EARNED INCOME TAX CREDIT

A state earned income tax credit is an easy, straightforward, and highly cost-effective way to help working families survive in Hawai'i. To this end, the state should create a refundable credit against state income taxes equal to at least 10 percent of a filer's federal EITC.

The federal EITC has been hailed as the most effective anti-poverty program in the U.S. From 2009–2011, the federal EITC raised 6.1 million workers out of poverty each year, and mitigated the effects of poverty on an additional 21.2 million workers.<sup>31</sup> In Hawai'i alone, some 108,000 residents,<sup>32</sup> including an estimated 13,000 military families,<sup>33</sup> benefit each year from the federal EITC. A refundable EITC puts money into the pockets of those who need it most. It not only reduces the tax burden on the low-income population, but also acts as a wage supplement and an incentive for employment because only workers with earned income can claim it. By raising families out of poverty, the EITC improves health and educational outcomes for children, and as an influx of cash, it can encourage families to build assets.



Earned income tax credits also boost local economies. According to a 2009 Michigan study by the Anderson Economic Group, for every dollar of federal EITC received by Michigan taxpayers an additional \$1.67 was generated in new earnings for Michigan residents. The study found that households receiving an EITC used most of their money on durable goods such as appliances or vehicles. This spending increases activity in the local economy directly and indirectly as it is re-spent.<sup>35</sup> A study on the impact of EITC dollars in California showed that for every \$150,000 claimed, an additional job was created.<sup>36</sup>

The federal EITC has been so successful at helping low-income households that **twenty-five states and the District of Columbia have followed the federal government's lead by enacting their own state EITC**, all calculated as a percentage of the federal credit.<sup>37</sup>

The significant benefits associated with adopting a state EITC include the following:

- **It is specifically aimed at families with children** — All low-income workers may claim the federal EITC—and therefore the proposed Hawai'i EITC—but the credit is much larger for taxpayers with children. The federal EITC lifts more children out of poverty than any other government program; a state EITC will help better address child poverty in Hawai'i.<sup>38</sup>
- **The Hawai'i EITC will be easy to apply for and administer** — Since it simply piggybacks on the federal EITC, calculating the state credit is simple. A taxpayer takes a set percentage of whatever was claimed for the federal EITC. Hawai'i should implement a credit pegged at 10 percent of the federal EITC. For example, if a family received a federal EITC of \$4,500, they would receive a \$450 (10 percent of \$4,500) refundable credit on their state taxes.
- **Refunds help low-income communities** — Most low-income workers who receive EITC refunds immediately spend them on household needs. Similarly, a Hawai'i EITC will inject money directly back into the local economy. A 10 percent state EITC would directly add roughly \$25 million to low and moderate-income communities throughout Hawai'i. However, because each dollar of EITC can generate up to \$1.67 of economic activity, the **overall economic benefit to Hawai'i communities is closer to \$42 million.**

Households that are not in immediate need can also opt to save their refunds. Almost 30 percent of Hawai'i's households are "liquid asset poor," meaning that they do not have enough liquid assets to survive for three months at the poverty level in the absence of other income.<sup>39</sup> A state EITC can help families achieve greater economic security and address this issue.

### Costs of a Hawai'i EITC

Hawai'i residents currently receive about \$250 million per year in federal EITC credits.<sup>40</sup> If Hawai'i were to adopt a 10 percent state EITC, the state could expect to spend approximately **\$25 million**; at 5 percent, approximately \$12.5 million.<sup>41</sup>



## 5 HAWAII SHOULD ADOPT A MORE EQUITABLE MINIMUM WAGE

All of Hawai'i's residents putting in a fair day's work deserve a fair day's pay. Yet many critical workers earn just \$7.25: the minimum wage required by federal law. This sum is hardly enough to survive in a state with the highest cost of living in the nation.<sup>42</sup> At the very least, a minimum wage should allow workers to provide themselves and their families with essentials including shelter, food, and transportation. Hawai'i should raise its minimum wage.

Increasing the minimum wage is a critical step to help families meet their basic needs. The Hawai'i Department of Business, Economic Development & Tourism estimates that for Honolulu County, economic self-sufficiency would require a wage of \$15.44 per hour for a single adult, while a couple with two children would need to earn \$16.35 each—all more than twice the minimum wage.<sup>43</sup>

From at least 1988 through 2007, Hawai'i set its minimum wage above the federal rate, reflecting the higher cost of living and our state's commitment to fair compensation for workers.<sup>44</sup> Yet this progressive stance has dissolved. Our minimum wage has not increased since 2007 and as a result lost significant ground to inflation. In the meantime, the federal minimum wage caught up with our state's upon the most recent federal increase in 2009.


In 2001, when the federal minimum wage was \$5.15 per hour, Hawai'i elected to gradually raise its \$5.25 minimum wage to account for our high cost of living. In 2007, with a newly mandated federal minimum wage of \$5.85, Hawai'i's minimum wage was raised to \$7.25, where it remains today. According to the Bureau of Labor Statistics Consumer Price Index Inflation Calculator, the actual buying power of the minimum wage in 2013 is worth just \$6.45. This decrease in value of over 20 percent effectively erased all of the gains made by workers in 2007. Yet during this same period, the average Hawai'i worker's weekly wage has actually *increased* 12 percent.<sup>45</sup>

Despite claims that raising the minimum wage will cost jobs, studies have not conclusively shown any correlation between an increase in the minimum wage and job loss.<sup>46</sup> Data from the Hawai'i Department of Labor and Industrial Relations clearly shows continued, and in one instance accelerated, job growth following the four increases in the minimum wage since 2002.

Raising the minimum wage also strengthens the economy. According to the Federal Reserve Bank of Chicago, a one dollar increase in the minimum wage results in \$2,800 of additional spending in households with adult minimum wage earners over the course of the year following an increase.<sup>47</sup> The National Employment Law Project estimates that increasing the Hawai'i's minimum wage to \$9.25 per hour will affect 74,000 workers and generate some **\$54 million in new economic activity**.<sup>48</sup> With a greater increase, the benefits would be even greater.

This economic benefit is magnified when an equitable minimum wage is combined with a state EITC. Many families with minimum wage workers earn so little that their incomes are in the phase-in range, where benefits continue to increase as income increases. As a result, a hike in the minimum wage can result in a larger federal EITC, bringing additional federal money into Hawai'i. For families without full-time employment, even a modest increase in the minimum wage would result in greater EITC refunds.

Although Hawai'i has the highest cost of living in the nation, 19 other states and the



District of Columbia have adopted higher minimum wages.<sup>49</sup> Hawai'i should follow their lead and increase the minimum wage. Increasing the minimum wage will not only prevent Hawai'i's wage earners from losing further ground, but it also stands to provide significant economic benefits to the state economy.

## THE IMPACT OF THE PROPOSED REFORMS ON HAWAI'I'S FAMILIES AND COST TO THE STATE

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## IMPACT ON FAMILIES

Hundreds of thousands of low and moderate-income families in Hawai'i will be more financially secure as a result of the proposed tax credit recommendations and an increase in the minimum wage. The table below offers three scenarios modeling how low-income households will benefit from a higher minimum wage, inflation-adjusted food/excise tax and low-income household renters credits, and the creation of a state earned income tax credit.

### THE EFFECTS OF THE PROPOSED REFORMS:

- Increasing minimum wage from \$7.25 to \$9.50
- Adjusting the low-income household renters credit (LIHR) for inflation
- Adjusting the food/excise credit (FETC) for inflation
- Creating a State Earned Income Tax Credit (SEITC)

#### Scenario 1: Single Individual Earning Minimum Wage

	Current	Proposed
Gross Income	\$15,080	\$19,760
LIHR	\$50	\$146
FETC	\$55	\$62
SEITC	N/A	\$0
Total State Refund*	\$252	\$311

#### Scenario 2: Single Parent With Two Children Earning Minimum Wage

	Current	Proposed
Gross Income	\$15,080	\$19,760
LIHR	\$150	\$438
FETC	\$165	\$186
SEITC	N/A	\$467
Total State Refund*	\$252	\$1,569

#### Scenario 3: Two Wage Earners (One Minimum Wage) With Two Children

	Current	Proposed
Gross Income	\$40,080	\$44,760
LIHR	\$0	\$584
FETC	\$140	\$160
SEITC	N/A	\$0
Total State Refund*	\$252	\$825

\* "Total Refund" amounts include the three credits and the filer's refunded standard withholdings.

## Cost to the State

The tax relief provided to low-income families will make a meaningful difference in their financial security; at the same time, the cost to our state is manageable, especially in conjunction with the revenue-raising measures recommended in the next section of this report.

The low-income worker credit would reduce reported income tax liability by approximately \$21.8 million, based on estimates provided by the Department of Taxation to the most recent Hawai'i Tax Review Commission in 2012 and adjusted for inflation during this past year.<sup>50</sup>

Based on the latest information available from the Department of Taxation,<sup>51</sup> and reasonable adjustments for changes in population, adjusting the existing food/excise tax and low-income household renters credits for inflation would cost the state approximately \$30.2 million.

A ten percent state EITC would cost the state of Hawai'i approximately \$25 million, a figure derived from Hawai'i residents' total federal EITC income of \$250 million.<sup>52</sup>

The **total cost** of these three policies would be approximately **\$77.0 million**.

Program	Cost (in millions)
<i>Low-Income Workers Credit</i>	\$21.8
<i>Updating Renters and Food/Excise Tax Credits</i>	\$30.2
<i>State EITC</i>	\$25
<i>Increased Minimum Wage</i>	\$0
<b>Total:</b>	<b>\$77.0</b>

# NEW REVENUE SOURCES TO COMPENSATE FOR TAX CREDIT ADJUSTMENTS

Hawai'i Appleseed recommends ten tax policy modifications that would generate substantial new revenues to help support the tax relief proposals described in this report and also create a more equitable and less regressive tax structure.

## 1 ELIMINATE THE STATE INCOME TAX DEDUCTION

Hawai'i is one of only seven states in the U.S. that allows taxpayers to deduct state income taxes they have paid during the course of a year when calculating their final state income tax bill for that same year.<sup>53</sup> This deduction is little more than an error in the tax code imported through an inartful copying of the federal tax system, which allows the deduction of state income taxes paid. Hawai'i's failure to require itemizers to add back the deduction has been criticized by tax and budget experts as "irrational," "nonsensical," and "poor tax policy." Nearly all states require that itemizers add back the federal deduction when calculating itemized deductions for state income tax purposes. In 2011, the Hawai'i legislature recognized the irrationality of this system and partially repealed the income tax deduction so that individual taxpayers with incomes over \$100,000 and married couples over \$200,000 could no longer take the deduction.<sup>54</sup> Were the state to take the sensible step of fully eliminating the state income tax deduction, the Department of Taxation estimates that Hawai'i would collect approximately **\$70 million** in new revenue.<sup>55</sup>

## 2 REINSTATE THE SURCHARGE ON RENTAL CARS

During 2011–2012, Hawai'i increased its surcharge on rental cars from \$3.00 to \$7.50 per day. That increase was allowed to sunset on July 1, 2012. In its report to the Tax Review Commission, the PFM Group recommended that this surcharge be restored to the 2012 rate, which would result additional revenues of more than **\$65 million**.<sup>56</sup> This increase has the advantage that it would be borne almost entirely by out-of-state residents and likely would have only minimal impacts on the tourist industry as demonstrated by the levels of travel activity during the period of the increased surcharge.<sup>57</sup>

## 3 ELIMINATE THE TAX BREAK FOR CAPITAL GAINS INCOME

The tax break given to capital gains is one of the most inequitable features of the Hawai'i state tax system. Our tax system gives preferential income tax rates to profits realized from the sale of investment assets such as stocks, bonds, investment real estate, art, or antiques. Again, Hawai'i is one of just eight states that provides a substantial tax break for capital gains income.<sup>58</sup> This preferential tax rate solely benefits upper-income taxpayers, with 92 percent of the benefit going to the richest one percent of Hawai'i residents.<sup>59</sup> Moreover, it is extended to non-residents who profit from trading investment assets, such as lo-

cal real estate, in Hawai'i.

The state should tax capital gains at the same rates as income from other sources, netting around **\$31 million**.<sup>60</sup>

## 4 REQUIRE ONLINE RETAILERS TO COLLECT HAWAI'I EXCISE TAXES

As online commerce continues to grow, many states throughout the U.S. have begun insisting online retailers collect sales taxes that would have been owed had the vendors been located in the state. Hawai'i should adopt similar policies so that the state can begin collecting these unpaid taxes on remotely-sold goods. Because online commerce diverts customers from local businesses, the states suffer both from decreased local economic activity and reductions in tax revenues. Customers may make online purchases to avoid paying sales tax, and local businesses can effectively function as showrooms for online vendors without benefiting from sales.

States' desire to collect these already-owed taxes resulted in the creation of the Streamlined Sales and Use Tax Agreement (SSUTA) in 1999. The SSUTA is a voluntary agreement among individual states to amend their sales/use tax structures to encourage online and mail order vendors to collect taxes. This not only ensures that the state receives the taxes already owed but places local brick-and-mortar shops (who have to collect sales/excise taxes) on a level playing field with online vendors. Twenty-four of the 45 states with sales or excise taxes have brought their tax codes into conformity with the agreement.<sup>61</sup>

Hawai'i would benefit immensely from excise taxes collected from online sales. Dr. William Fox, a professor of economics at the University of Tennessee who has advised every Hawai'i Tax Review Commission since the 1980s, estimates that collecting online and mail order taxes could generate as much as **\$183.3 million**. As online commerce continues to grow, that figure is projected to increase to **\$211.2 million** by 2015.<sup>62</sup> These uncollected taxes would provide a significant benefit to state revenues and level the playing field for local businesses.

Another option is designating the use of future online sales tax revenues toward alleviating the tax burden on lower-income households. A proposed law currently pending in Congress, the Marketplace Fairness Act, would enable states to collect sales and use taxes from online and other remote retailers. Hawai'i could pass a state law dedicating tax revenues from online sales to low and moderate-income tax relief in anticipation of the Act's passage.

## 5 ELIMINATE THE "DIVIDENDS PAID" DEDUCTION FOR REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REITs) are business entities developed in the mid-1960s to enable small investors to invest in income-producing real estate.<sup>63</sup> A REIT is a type of company consisting of at least 100 shareholders, with most of its assets held in real estate, and it must pay out at least 90 percent of its income in dividends.<sup>64</sup> A REIT is taxed as a corporation but allowed to deduct all of its dividend payments from its taxable income. This differs from most corporations, which have to pay corporate-level taxes on any divi-



dends distributed to shareholders. While these shareholders must still pay income taxes on the dividends that they receive, the REIT itself is often able to avoid all corporate income tax liability.

Because of this tax structure, much of the income produced by local real estate goes untaxed in Hawai'i. For example, a New York resident can buy shares in a REIT that has all of its property holdings in Honolulu. None of the REIT's income will be subject to Hawai'i state income tax as long as the REIT pays out any income produced to its shareholders as dividends. The shareholder then pays personal income taxes only in her home state of New York, where she is a resident. The net result: money made off of Hawai'i's land generates tax revenues in New York, while Hawai'i receives nothing.

Because there are so many REITs in Hawai'i, and because the majority of REIT shareholders do not live in Hawai'i, estimating the exact amount of revenue that the state is losing is difficult. However, analyses of the larger REITs that own property in Hawai'i suggest potential tax revenues from **\$30–\$50 million**.

## 6 PREVENT HIGH-INCOME TAXPAYERS FROM BENEFITING FROM LOWER TAX BRACKETS

Hawai'i has already enacted some sensible limits on tax breaks that disproportionately benefit the state's most affluent residents, such as capping the total value of itemized deductions and phasing out the personal exemption for high-income taxpayers.<sup>65</sup> However, the state still allows its wealthiest households to benefit from the lower tax brackets designed to benefit middle and lower-income residents.

While Hawaii's maximum marginal tax rate of 11 percent kicks in at \$200,000 for a single taxpayer and \$400,000 for married couples filing jointly, households above these income levels do not pay an 11 percent tax on all of their income. Even multimillionaires benefit by having the first \$400,000 they earn in any given year taxed at the state's lower marginal tax rates of 1.4 percent to 10 percent.

While this marginal tax rate structure may make sense on the whole, three states—Connecticut, Nebraska, and New York—have made it more equitable by enacting measures that gradually phase out these lower rates for the very richest taxpayers.

Adopting a similar approach in Hawai'i would raise millions of dollars in additional tax revenues and reduce the intense regressivity of the state's overall tax system.

## 7 CREATE A SINGLE NET CORPORATE INCOME TAX RATE

Hawai'i currently taxes corporate income at different rates based upon income, in tax brackets ranging from 4.4–6.4 percent.<sup>66</sup> This tiered corporate tax structure is somewhat unique; 31 other states have a single rate.<sup>67</sup> A multi-bracket income tax structure makes sense for an individual income tax because residents with lower incomes are less able to afford a large tax burden. However, there is no such similar "ability to pay" concept for corporations.<sup>68</sup> Moreover, our top corporate income tax rate is the 19th lowest in the nation,

and our per-capita corporate tax collections are the 9th lowest.<sup>69</sup>

Following the PFM Group's recommendations to the 2012 Hawai'i Tax Review Commission, consolidating our corporate income tax brackets and raising the net corporate income tax rate to 9 percent is projected to generate approximately **\$34.8 million** in new revenues.

## 8 ELIMINATE TAX BREAKS FOR WEALTHY RETIREES

As Hawai'i's population ages, the revenue lost by exempting retirees' pension income from tax will grow significantly. In 2011, the state legislature considered taxing pension income received by the state's upper-income residents. The proposals balanced the need for adequate long-term revenues with the desire to limit taxes on less affluent members of the state's older population, including those who do not receive pensions. Hawai'i's lawmakers should revive these proposals and gradually phase out the pension exclusion for wealthy retirees.

By completely exempting pensions from taxation, Hawai'i is unfairly shifting the tax burden from wealthy retirees to working taxpayers, including working seniors. Providing a reasonable exemption would protect low-income and middle-class older adults who are struggling economically while also ensuring that everyone pays their fair share.

Currently, Hawai'i is one of only ten states to provide a blanket exemption for government pensions, regardless of income or wealth. It also offers one of the most generous private pension exemptions in the country.<sup>70</sup> A majority of states cap each taxpayer's maximum pension exemption at some amount, limit the exemption to taxpayers below a specific income level, or offer no specific pension exemption at all.<sup>71</sup>

By requiring wealthy retirees to shoulder their fair share of the tax burden, Hawai'i would increase tax revenues while starting to reform the disparity inherent in special exemptions based exclusively on a taxpayer's age, rather than ability to pay.

Modifying current exemptions for pension income would not only generate significant revenue immediately, but it would also provide a robust source of continued revenues for the state in future years. According to testimony given by the Abercrombie administration in 2011, estimates for revenue gains under the governor's previously proposed thresholds were approximately **\$191.3 million in fiscal year 2013**, and **\$206.7 million for fiscal year 2014**.

## 9 ELIMINATE THE PROPERTY TAX DEDUCTION

Under almost any measure, Hawai'i has one of the lowest property tax rates in the nation.<sup>72</sup> Because Hawai'i is unique in funding its single public school district entirely from the state general fund, money that would normally be collected via county property taxes to fund schools is instead taken from state revenues. In essence, all state taxpayers are subsidizing property owners by providing funding for education that would normally be collected in property taxes.<sup>73</sup>

In addition to these low rates, Hawai'i follows the federal treatment of income by allowing a deduction for property taxes paid. The federal government gives this deduction be-

cause property taxes are generally the primary source of funding for local schools. As a result, Hawai'i's property owners receive an additional tax benefit. They are also fortunate enough to have an opportunity to build equity in a major asset, while lower-income households stuck renting do not receive any tax or long-term investment benefits.

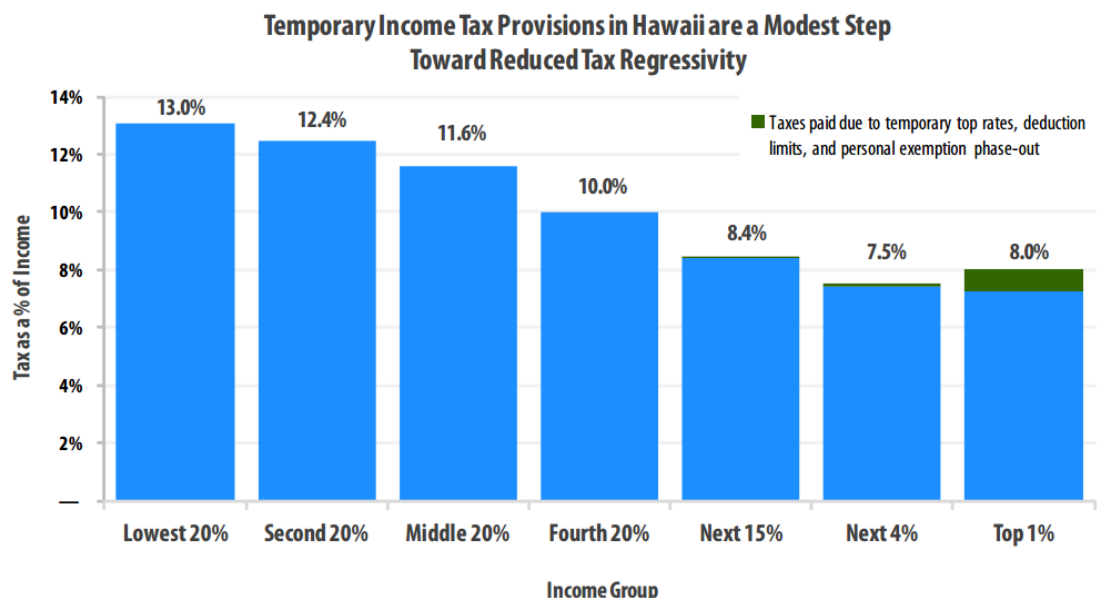
The property tax deduction does not even benefit everyone who pays property taxes. Only those taxpayers who itemize deductions are able to benefit from the property tax deduction. Meanwhile, property taxes are passed along to renters in the form of higher rents, but they do not receive a similar tax write-off.

In its report to the Tax Review Commission, the PFM Group projects that simply removing the property tax deduction would generate **\$12.5 million** in new revenue.<sup>74</sup>

## 10 PREVENT THE 2009 TAX INCREASE ON WEALTHY HOUSEHOLDS FROM SUNSETTING

In 2009, the state increased income tax rates on individuals making over \$96,000 per year to address budget shortfalls resulting from the Great Recession (rates increased by as much as 2.75 percent for singles/married couples making over \$200,000/\$400,000 per year). At the same time, lawmakers enacted new limitations on itemized deductions and created a phase-out of the personal exemption for higher-income households, while also increasing the basic personal exemption and standard deduction by 10 percent. The personal exemption and standard deduction increases have since been made permanent, but the rate increases, limitations on itemized deductions, and the phase-out of the personal exemption are all set to expire at the end of 2015. Hawai'i should extend these progressive policies by making them permanent.

According to estimates provided by the Department of Taxation during last year's legislative session, allowing the expiration of these tax increases on the highest-income households would cost the state **\$48.6 million** in 2016, the year after the tax increases are set to end.<sup>75</sup>



Even if Hawai'i were to conclude it could afford to lose this revenue from its wealthiest taxpayers—which it cannot—there are far better ways to allocate this money to reduce the tax burden on residents who can least afford to pay. As shown by the chart above, the most apparent effect of allowing these changes to expire would be to lower the effective tax rate paid by Hawaii's wealthiest residents from 8.0 percent to 7.3 percent. Instead of giving tax breaks to the wealthy, Hawai'i should implement progressive reforms by expanding the low and moderate-income credits discussed in this report. Any tax cuts Hawai'i chooses to make should benefit families who are already struggling to make ends meet. Allowing these tax cuts to expire will only make Hawai'i's tax system even more regressive.

## Total Estimates of Potential Revenue

Program	Potential Revenue
Eliminating State Income Tax Deduction	\$70 million
Reinstating Rental Car Surcharge	\$65 million
Eliminating Capital Gains Tax Break	\$29 million
Collecting Online Sales Taxes	\$183.3 million
Eliminating Dividends Paid Deduction for REITs	\$40 million
Creating Single Corporate Tax Rate	\$34.8 million
Eliminating Tax Breaks for Wealthy Retirees	\$206.7 million
Eliminating Property Tax Deduction	\$12.5 million
Retaining High-Earner Tax Increases	\$48.6 million
<b>Total:</b>	<b>\$689.9 million</b>

stead of giving tax breaks to the highest-income households and wealthy corporate entities, Hawai'i should implement progressive reforms by expanding the low and moderate-income credits discussed in this report. Any tax cuts Hawai'i does choose to make should benefit families who are already struggling financially. These proposals would make a meaningful difference to help families make ends meet and can be balanced by the proposed revenue-raising measures, which would more than cover the cost of tax relief for working families. Especially during these difficult economic times when low and moderate-income people are struggling to stay afloat, we should be helping them up, not pushing them deeper.

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