

STATE TAX RELIEF IN HAWAI‘I

The State of Hawai‘i has a big public policy problem—a \$580 million surplus. Sure, things could be worse. But it is often more difficult to use money wisely when you have more of it. Surpluses unearth billions of dollars worth of “priorities” that have long been “neglected.” Some are extremely important, some less so and some are downright wasteful. Add to this the temptation, whether real or perceived, to seek political gains and you have some difficult situations that require thoughtful solutions. One such question facing lawmakers in 2006 is whether to provide state tax relief and if so, to whom and how. This guide attempts to clarify the issues and some of the political statements that cloud our collective ability to make the best decisions.

Five Important Points

1. Some people *really* can’t afford to pay taxes
2. There are three specific reasons to give relief to those who *can’t afford taxes*
3. Different tax relief proposals do different things
4. Tax relief costs money – now and in the future
5. Relief for people who can’t afford taxes can make a big difference

FIVE THINGS TO KNOW

#1 – Some people *really* can’t afford to pay taxes

There is a way to identify those who truly can’t afford taxes. Imagine shopping for just enough food so your family isn’t hungry, renting the most basic housing, buying a bus pass to go to work, getting minimal healthcare, childcare, and other basic necessities. The total real cost of these goods and services is called the *self-sufficiency standard*; some call the amount that you must earn, a *living wage*. The amount differs depending on your family makeup and where you live—for example, when the self-sufficiency standard was last calculated for Urban Honolulu in 2002, a single person with no children needed about \$18,000 per year; a single parent with a preschooler needed \$31,000; a couple with two school-age children needed \$37,000. The self-sufficiency standard is a meaningful measure because we know that anyone below it must be dependent on government and/or the charity of individuals and organizations in order to avoid homelessness, joblessness, hunger, and other calamities. An estimated 100,000 taxpayers plus their dependents live below the self-sufficiency standard in Hawai‘i.

#2 – Three specific reasons to give relief to those who *can’t afford taxes*

Almost everybody feels overtaxed. That might seem like a reason to give tax relief to everyone. But for Hawai‘i residents with very low incomes, there are three unique, widely accepted, non-ideological reasons to reduce income tax and excise tax burdens.

First, *the state income tax burden is out of step with the rest of the nation*. Hawai‘i is among the worst states for taxing the incomes of the working poor, including those well below the poverty level. For example, a single mother with two children making minimum-wage earnings—a mere \$13,000 per year—must pay \$155 in state income taxes.

Second, *the state general excise tax burden is unfair*. While the general excise tax has many positive features, one of its glaring negatives is its regressivity—the poorest taxpayers pay 10% of their incomes in general excise tax while the richest pay only 2%.

Third, *taxing the poor keeps them poor*. People below the self-sufficiency line are, by definition, dependent on others to survive. When government collects taxes from people who literally cannot afford them, it creates an even greater dependency on, among other things, government. This is absurd. Unlike policies aimed at wealthier, higher-income earners, existing policies for low-income earners create a disincentive to earn more, save, and escape poverty. For people below the self-sufficiency standard, getting a job promotion or funding a savings account can actually be economically detrimental.

YOU HEARD IT: *“We need to provide tax relief to struggling people... people living paycheck-to-paycheck.”*

These statements and others like them are well intentioned, but they can be confusing. By living outside one’s means, even high-income earners can live paycheck-to-paycheck, and many people are struggling based on their own definition of “struggling”. We all must remember that people below the self-sufficiency standard are struggling in a fundamentally different way; they are *economically dependent* on others. There may or may not be a good reason to give tax relief to everyone, but this question is apart from the more compelling case to provide relief for those who truly can’t afford taxes.

YOU HEARD IT: *“The best tax relief package is the one that affects the most people”*

One would expect that an expensive, broad tax relief package should help more people than a smaller targeted one. But that doesn’t necessarily make it better. The best package will do the best job of helping the intended recipients in the best ways.

#3 – The different tax relief proposals do different things

There are three primary proposals being considered by Hawai‘i lawmakers in 2006:

Update the basic elements of the income tax. This includes raising the standard deduction (proposed by the Governor) and altering the tax brackets (proposed by the Governor and Senate). Although apparently not on the table, raising the personal exemption and adjusting tax rates are also improvements that could be made. Some of these tax code elements have not been updated to account for inflation in decades. These long overdue upgrades, if smartly designed, would help address the first problem mentioned in #2 above—that Hawai‘i is out of step with the rest of the nation in terms of how much we tax the working poor.

Refundable low-income tax credit. This is often called a food/medical tax credit (proposed by the Governor) because it ostensibly refunds general excise taxes on these items. A well-targeted credit of this sort could go a long way toward addressing the second problem—the unfair regressivity of the state general excise tax.

Refundable state earned income tax credit (EITC). This policy (supported primarily in the House) is excellent for dealing with the third problem—taxes keep poor people poor. Because of the way it is designed, a refundable EITC encourages work and addresses the generational nature of poverty by providing extra help to families with children. A state EITC would provide one of the few policy incentives for low-income earners and their children to move toward economic independence.

YOU HEARD IT: *“My idea is better than your idea”*

Many of the proponents of these different tax relief plans are fierce political rivals. But arguing over whose proposal is better is like arguing whether a saw, hammer or screwdriver is better for building a house. The tools do different, important things. If fiscal or political realities eliminate one or two of the main three tax relief proposals, lawmakers need to acknowledge that some public purposes will not be well served.

#4 – Tax relief costs money—now and in the future

Cutting taxes has a cost—sometimes called an opportunity cost—because government no longer has those revenues to produce social goods. So while most taxpayers like the idea of more money in their pockets, they also like having the things that government provides such as public safety, education, parks, roads, etc. Permanent tax policy changes affect not only this year’s revenues (when times are good), but also future years when times may not be good.

YOU HEARD IT: *“It’s a good time to talk about tax relief because we have a surplus”*

If there were no surplus, it would be nearly impossible to propose tax relief without also proposing other tax increases or spending cuts. Unless you think the good times will roll on forever, the existence of a surplus just postpones talk of tax increases or spending cuts to a later date—perhaps when some others are in office to deal with it. This isn’t a *good* time to talk about tax relief; it’s just an *easy* time.

YOU HEARD IT: *“You can use the money better than government can”*

The simplistic argument that government does not deserve or need “additional” taxes because it is corrupt or inept is appealing—in part because it is too often true, and in part because it appeals to self-interest. But the fact is, only government can equitably produce certain public goods that people want and need. Fiscal responsibility demands that government makes effective and efficient use of tax dollars. But it also demands that government collects enough taxes to adequately invest in society and provide the common goods that we all want and need.

#5 – Tax relief for people below self-sufficiency can be life-changing

The two refundable tax credit proposals, in particular, can give people a substantial foothold to begin a savings account, invest in education and training, pay off high interest debt, or purchase necessities. Additionally, the EITC provides focused attention on children in poverty and reduces the disincentive to work for people with the lowest levels of income.

YOU HEARD IT: *“Tax relief is peanuts (or plate lunches)”*

What’s an extra few hundred dollars when you’re below self-sufficiency? A lot. Of course for those with higher incomes, these amounts become less valuable. If you have enough money to feed your family, an extra plate lunch per week does seem worthless. This is precisely why tax relief should be well targeted to those who need it most.

3POINT'S POINT OF VIEW

A combined approach would be best. Granted, it may be politically infeasible given the partisan atmosphere and it may be fiscally difficult depending on a smart assessment of other public priorities. But if we are just focusing on the goal of tax equity, a combined approach that is carefully targeted and sized would be best:

1. Establish a **refundable state EITC**. This is already well targeted to low-income families with children. Republicans and Democrats have established state EITCs in 18 states because they create incentives to work and opportunities for families to invest in their futures. An EITC can also be viewed as a concentrated, people-based investment into low-income communities. By establishing an EITC in Hawai'i, the state will show that it is not just trying to help poor families out; rather it is trying to help poor families *out of poverty*.
2. Establish a well-targeted, **refundable low-income (food/medical) tax credit**. This will provide well-justified general excise tax relief to people, including those without children and older residents who may not benefit from an EITC. However, in the existing proposal, a self-sufficient single person with no children making \$50,000 would be eligible for the credit. This is one indication that the credit can be better targeted than it is now and its total cost can be reduced.
3. **Update the income tax** with a *well-analyzed* combination of adjustments to the standard deduction, personal exemption, brackets, and/or rates so that we increase the threshold at which incomes are taxed. Current proposals, while having a positive effect on low-income earners, are so extensive that much of the relief goes to middle- and upper-income people—a less compelling outcome in our view.
4. Any changes to the tax code must also **provide for periodic indexing** to account for inflation. *This will benefit all taxpayers*. Without indexing, inflation has a constant downward pressure that, in essence, causes a perpetual income tax increase that is detrimental to all taxpayers. Without indexing, we will be having this same debate in a few years.
5. Provide for the regular updating and application of **the self-sufficiency standard**. It is one of the most useful and relevant measures for creating, choosing, evaluating and adjusting public policy including tax policy.

As for additional tax relief or a one-time tax refund for those who are self-sufficient, maybe it is a good idea and maybe not. It depends on other social priorities this year and in the future. We simply hope that this debate is an informed one that is honest with the public in examining the benefits gained, the opportunities lost, and the long-term financial impacts. It is too easy for politics to contaminate this debate at the expense of fiscal responsibility.

Tax relief for those who cannot afford taxes is not an act of charity to the poor. Rather, it is a statement of policy that people ought not be trapped in a cycle of poverty—that equal opportunity is a democratic necessity. Along with the creation of better paying jobs, and ensuring preparation and access to these jobs, a more equitable tax structure will establish Hawai'i's commitment to end poverty within our shores.

▼ Five Point Plan

1. Refundable state EITC
2. Targeted refundable food/medical credit
3. Update income tax to raise threshold
4. Indexing of income tax elements
5. Utilization of the self-sufficiency standard

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Pauahi Tower, Suite 2605 ▼ 1001 Bishop Street ▼ Honolulu, Hawai'i 96813
808.521.3995 ▼ ideas@3pointconsulting.com ▼ www.3pointconsulting.com