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An Evaluation of Proposals to Provide Tax Relief to Low-Income Families in Hawai'i

RATIONALE FOR TAX RELIEF

The self-sufficiency standard (a.k.a. "living wage") for a one-parent, one-child family in Hawai'i is approximately \$36,000. This is the amount needed to afford the bare-minimum costs of housing, childcare, food, transportation, health care, taxes and other necessities without the benefits of public assistance, such as Food Stamps or the Children's Health Insurance Program.¹ About 80,000 families in Hawai'i earn less than \$35,000 per year, including 21% of all two-parent families and 52% of all families headed by single mothers.²

THE POINT

Hawai'i state taxes place illogical burdens on low-income earners. If the goal is to help these residents, then a refundable state earned income tax credit (EITC) is the most effective proposal. Increasing the standard deduction and providing a food/medical tax credit fix inequities in the tax code, but these policies have a more muted, less strategic effect on helping people become economically independent.

Self-defeating public policy #1: Taxes on people with less than self-sufficient incomes

Hawai'i's poorest taxpayers pay 10% of their incomes in general excise tax (GET) while the richest pay only 2%.³ Hawai'i is also among the four worst states for income taxes on poor families⁴—a single mother of two, who earns \$10,000 and is dependent on state subsidies, is currently required to pay state income tax. A disproportionate tax burden on individuals and families who earn less than a self-sufficient wage adds to economic insecurity, curbs job advancement opportunities and, ironically, creates greater dependence on the public subsidies that are funded by those taxes.

Self-defeating public policy #2: Financial disincentives to become economically independent

Mid- and high-income Americans can access numerous tax incentives and subsidies to earn more and build wealth—deductible mortgage interest, 401Ks for retirement, and 529 plans for education are a few examples. By contrast, taxes and other public policies aimed at people with less than self-sufficient wages often create financial disincentives to earn and save more. In many cases, benefits are reduced and tax burdens increased when a person builds assets and makes progress toward the self-sufficiency standard. These disincentives keep families and future generations trapped in a state of poverty.

POLICY DESIGN GOALS

If the aim is to help the working poor, a new set of tax policies should achieve the following:

1. **Reduce taxes on low-income earners.** Hawai'i's regressive GET and its low income tax threshold cause insufficient incomes to be even less sufficient. Taxes can be reduced by eliminating income taxes on low-income earners and by providing a refundable tax credit. A refundable tax credit to someone who owes and pays no *income* tax is not a disguised "handout." It is, in fact, a refund of some of the *GET* that the person has paid through consuming goods and services. If these fixes to the tax system are made, an examination of the resulting tax structure may be warranted to ensure adequate revenues and fairness in the system's entirety.

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POLICY DESIGN GOALS

1. Reduced taxes on low-income earners
2. Incentives to work
3. Economic stimulus
4. Maximum utilization
5. Minimum administrative costs
6. Maximum social benefits to costs

2. **Create incentives to work.** Government can “make work pay” by creating incentives to increase earnings and savings while a low-income earner strives toward economic independence. This helps counter the disincentives inherent in traditional public subsidies.
3. **Provide a meaningful economic stimulus.** Tax relief that effectively puts money into the pockets of people with low incomes is akin to programs aimed at low-income communities. Focused tax relief can increase local economic activity and wealth building which, together with traditional work supports and community investments, form a powerful anti-poverty strategy.⁵
4. **Maximize proper utilization.** New tax policies should be simple and accessible to ensure maximum participation of the intended beneficiaries. There should also be measures to avoid misuse or abuse of the tax system that would thwart its intended purposes.
5. **Minimize administrative burden.** Administrative costs vary depending on the tax policy. They may include the costs of educating the public, identifying and reducing errors, identifying and reducing fraud, and producing and processing new forms.
6. **Maximize social benefits in light of costs.** The primary “costs” of these tax proposals are foregone income tax and GET revenues either not collected or refunded. From a state budgetary perspective, these are real costs that must be considered in relation to all other public priorities.

NEW POLICY PROPOSALS

In this brief, we evaluate three prominent tax reform proposals intended to “help those individuals and families who are living paycheck-to-paycheck.”⁶

Increasing the standard deduction

Hawai‘i’s standard deduction (SD) amounts have not changed since 1989 and the personal exemption (PE) has not changed since 1985. The single, joint, and head of household SD is currently \$1,500/\$1,900/\$1,650 and the PE is \$1,040. If these amounts kept up with inflation, they would now be approximately \$2,225/\$2,820/\$2,450 and \$1,860. The 2004 federal SD is \$4,850/\$9,700/\$7,150 and the PE is \$3,100. A number of proposals are being considered including one to conform to the IRS and another to reach 60% of the IRS SD and 50% of the IRS PE by 2007. In this brief, we present findings on the Governor’s proposal to increase the standard deduction to reach \$2,500/\$5,000/\$3,650 by 2008. We estimate that these SD levels would cost \$22 million per year.

Refundable Food/Medical Tax Credit

Proposals are being considered to create a refundable tax credit for food and medicine. Before it was repealed in 1998, Hawai‘i had a similar tax credit based in part on the theory that it is inappropriate to charge the GET on some items that are necessities for life. The current proposals are targeted at low-income earners including one which would provide a food credit that anyone can claim and that gets increasingly larger for taxpayers earning \$30,000 or less, as well as a medical tax credit calculated separately, and bonus provisions for those 65 or older. In this brief, we discuss the Governor’s proposal to provide a \$55 credit per exemption for anyone earning \$40,000 or less. We estimate this proposal would cost \$24 million per year.

Refundable State EITC

A state EITC would be available to those who are eligible for the federal EITC. For 2004, this includes families with two or more children earning \$35,000 or less, families with one child earning \$31,000 or less, and individuals earning \$12,000 or less. A refundable state EITC would be set as a percentage of the federal credit. The federal EITC (and thus, a state EITC as well) is designed to create a work incentive—credits *increase* as people earn more, reach a plateau, and phase out as incomes become more self-sustaining. This brief looks at a 20% state EITC, which would cost an estimated \$23 million per year.

NEW PROPOSALS

1. Increase standard deduction
2. Food/medical tax credit
3. State EITC

POLICY EFFECTS ON LOW-INCOME TAXPAYERS

We modeled the effects of changes in the tax code on low-income taxpayers. Below are a sampling of results comparing the proposed increase in the standard deduction (ISD), the food and medical tax credit (FMTC) and a state EITC.

Net benefit for various filing types by adjusted gross income (AGI)

STATUS/ CHILDREN	AGI = \$15,000				AGI = \$25,000			
	Current Income Tax	Net Benefit			Current Income Tax	Net Benefit		
		ISD	FMTC	EITC		ISD	FMTC	EITC
Single / 0	\$589	\$66	\$55	\$0	\$1,315	\$76	\$55	\$0
Single / 1	\$408	\$110	\$110	\$469	\$1,074	\$136	\$110	\$170
Single / 2	\$341	\$110	\$165	\$789	\$1,004	\$136	\$165	\$397
Single / 3	\$273	\$110	\$220	\$779	\$933	\$133	\$220	\$397
Married / 0	\$330	\$169	\$110	\$0	\$945	\$198	\$110	\$0
Married / 1	\$263	\$145	\$165	\$491	\$879	\$199	\$165	\$202
Married / 2	\$196	\$121	\$220	\$820	\$812	\$197	\$220	\$439
Married / 3	\$131	\$99	\$275	\$810	\$746	\$188	\$275	\$439

Net benefit for various income levels by filing status

AGI	SINGLE, 1 CHILD				SINGLE, 2 CHILDREN			
	Current Income Tax	Net Benefit			Current Income Tax	Net Benefit		
		ISD	FMTC	EITC		ISD	FMTC	EITC
\$5,000	\$0	\$18	\$110	\$272	\$0	\$3	\$165	\$297
\$10,000	\$103	\$70	\$110	\$471	\$38	\$64	\$165	\$727
\$15,000	\$408	\$110	\$110	\$469	\$341	\$110	\$165	\$789
\$20,000	\$741	\$128	\$110	\$330	\$675	\$128	\$165	\$608
\$25,000	\$1,074	\$136	\$110	\$170	\$1,004	\$136	\$165	\$397
\$30,000	\$1,423	\$144	\$110	\$10	\$1,349	\$141	\$165	\$187
\$35,000	\$1,789	\$150	\$110	\$0	\$1,709	\$144	\$165	\$0
\$40,000	\$2,169	\$152	\$110	\$0	\$2,089	\$152	\$165	\$0

Who will get the tax cut?

	Estimated Total Tax Cut	TAX FILER'S ADJUSTED GROSS INCOME				
		\$20,000 or less	\$20,000 - \$30,000	\$30,000 - \$50,000	\$50,000 - \$75,000	\$75,000 or more
INCREASE STD. DEDUCTION	\$22 million	\$9.0 million 41%	\$5.4 million 25%	\$4.9 million 22%	\$2.3 million 11%	\$0.2 million 1%
FOOD/MED TAX CREDIT	\$24 million	\$11.4 million 48%	\$7.0 million 29%	\$5.5 million 23%	N/A 0%	N/A 0%
STATE EITC	\$23 million	\$17.3 million 75%	\$5.6 million 24%	\$0.3 million 1%	N/A 0%	N/A 0%

NOTES ON METHODOLOGY

Net benefits based on 2004 state tax rates and federal EITC tables

Single taxpayers with children are assumed to file as "Head of Household"

Married taxpayers are assumed to file joint returns

Current tax owed is offset by the existing low income tax credit available to people earning less than \$20,000

"Net Benefit" of FMTC assumes everyone eligible also takes the low income tax credit

"Net Benefit" of the EITC reflects a provision in the proposal that precludes taking multiple tax credits

Costs of the three proposals are estimated from 2002 state and IRS resident tax return data adjusted for population and income growth to project present day amounts

Actual proposals have phase-in provisions before full effect; we compared the costs in 2005 dollars as if all were in full effect

Although ISD would also benefit non-resident filers, these costs are not included in this analysis

CONCLUSIONS

The following summarizes the different proposals. It is important to understand that each policy is best suited to accomplish a different public objective.

	INCREASE STANDARD DEDUCTION	FOOD/MEDICAL TAX CREDIT	STATE EITC
WHO BENEFITS?	Anyone who does not itemize, regardless of income or family structure. Low- and middle-income earners are more likely to use the standard deduction. Non-residents filing Hawai'i income tax may also benefit.	Any household below \$40,000 including those with no incomes. Benefit size is independent of income level once below \$40,000. Benefit increases with number of dependents.	Benefits focused on families with children, earning ~\$30,000 or less. Limited benefits for households with no children, no benefits for households with no income, and no additional benefits for having more than two children.
WORK INCENTIVE?	None	None	Yes. Refund rises, plateaus, and phases out as income rises.
ECONOMIC STIMULUS?	Practically none. Benefits generally appear in slightly higher paychecks.	Minimal. May generate comparatively small refunds for additional consumption.	Yes. Provides high need families with large refunds, likely to be saved or spent on necessities. Encourages acquisition of the federal EITC.
ADDRESS INCOME TAX PROBLEM?	Yes. Eliminates income tax on the lowest income earners.	Reduces income tax burdens, but not the intention.	Reduces income tax burdens, but not the intention.
ADDRESS GET REGRESSIVITY?	No. Only reduces income taxes.	Yes. Roughly compensates low-income consumers.	Somewhat, but less evenly than FMTC.
UTILIZATION?	Easy to elect by any taxpayer who finds it economically beneficial. 44% of filers in 2002 took the state's standard deduction. If it is raised to proposed levels, we estimate 55% will elect the standard deduction.	Easy to elect if you know about it. 66% of eligible filers in 2002 took the refundable low income tax credit. We modeled what would happen if 85% took the larger FMTC.	Easy to get if already applied for the federal EITC. An estimated 75-85% of eligible households get the federal EITC. The federal EITC is complicated, so increased access to tax preparation assistance is critical. We estimate 90% of federal EITC recipients will get the state EITC.
ADMINISTRATION?	Minimal administrative burden.	Substantial state-initiated taxpayer and tax preparer education to reach 85% participation. State-specific efforts to identify errors or fraud.	Taxpayer and tax preparer education and efforts to identify errors or fraud can piggyback on IRS efforts.
OTHER CONSIDERATIONS?	If an increase is not accompanied with a provision to index for inflation or is not set as a function of the IRS figures (which are indexed annually), then the current income tax problem will arise again at some future date.	A proposal making the credit available to all will do considerably less to address GET regressivity. A proposal for an increasing credit for lower incomes could create a work disincentive for large low-income families.	Hawai'i's high cost of living would suggest that the federal EITC phase out begins at too low an income level. State income taxes on the poor exacerbate this. A combination of a state EITC and increasing the standard deduction would help.
THE BOTTOM LINE	Best for solving the income tax problem . Does little on its own to help people out of poverty.	Best for compensating for regressive GET in a fairly equitable way. Does little to promote economic independence.	Best for helping low-income families get out of poverty. Reduces taxes in a way that is concentrated and strategic.

Notes

¹ Hawai'i State Commission on the Status of Women, *The Self-Sufficiency Standard for Hawai'i*, April 2003.

² US Census, 2000.

³ Institute on Taxation and Economic Policy, *Hawai'i Taxes Hit Poor & Middle Class Far Harder than the Wealthy*, January 7, 2003.

⁴ Center on Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families in 2003*, April 8, 2004.

⁵ See The Brookings Institution, *The "State" of Low-Wage Workers: How the EITC Benefits Urban and Rural Communities in the 50 States*, February 2004.

⁶ Legislative intent from the Governor's *State of the State Address* delivered on January 24, 2005.