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A STATE EITC IS A COST-EFFECTIVE WAY TO EASE HAWAII'S HIGH INCOME TAX BURDEN ON THE POOR

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KEY FINDINGS

- **Hawaii's income tax is one of the most burdensome on the poor in the nation.**
- **Last year's tax cut (Act 110) did relatively little for low-income working families**
- **A state Earned Income Tax Credit (EITC) would improve Hawaii's income tax treatment of the poor more than Gov. Lingle's proposal, and at far less cost.**
- **An EITC also has other benefits such as reducing poverty, increasing workforce participation, and ease of administration.**

Hawaii continues to impose a higher income tax burden on low-income working families than almost any other state. A costly tax cut enacted in 2006 did little to address this problem. As a result, Hawaii continues to collect income tax from families with income thousands of dollars below the poverty line. And families in poverty continue to owe hundreds of dollars per year — a significant sum for a poor family.

When the legislature passed last year's tax cut package, it was widely believed that the bill would alleviate Hawaii's income taxation of the poor. But analysis of the bill soon proved otherwise. Gov. Lingle recognized that the job was unfinished and — even as she signed the bill — pressed for further action on behalf of low-income working families.[1]

Meanwhile, other states that in recent years have placed heavy income tax burdens on poor families have moved to address the problem. As a result, Hawaii's income tax still ranks among the harshest in every measure of tax burden on the poor, and by some measures is actually worsening.

The 2007 legislative session offers a fresh opportunity for Hawaii to bring its income taxation of the poor into the mainstream of states, most of which do not tax the poor. Two major proposals are under consideration:

- The first, introduced by Gov. Lingle as part of a broader tax package, includes increases in the standard deductions and income exemptions available to taxpayers, as well as annual indexing of income tax parameters. These measures would cost the state treasury about $60 million in 2007.

[1] In a press release from the governor's office dated May 19, 2006, the governor's tax director was quoted as saying, "Under this measure Hawai`i moves from the second worst to the fifth worst state, in terms of taxing the poor…. This is not good enough and the Governor has asked my department to again strongly advocate for additional tax relief next year."

- The second is a state Earned Income Tax Credit (EITC), which would cost about $24 million.

While either proposal would reduce the tax burden on the poor, an EITC is better targeted to low- and moderate-income families. As a result, a state EITC equal to 20 percent of the federal EITC would provide greater relief to low-income families than the governor's plan, and at less cost.

Despite last year's tax cuts, Hawaii still levies among the highest taxes in the nation on the income of poor working families

In early 2006, a report on all 42 state income taxes (counting the District of Columbia) found that in 2005 Hawaii's income tax imposed one of the heaviest burdens in the nation on low-income working families.[2] When in April of 2006 Alabama passed a major tax cut for low-income families, Hawaii assumed the dubious distinction of the nation's biggest taxer of the income of the working poor under its income tax.[3]

Last Year's Act 110 Did Little for Low-Income Working Families

In May of 2006, Hawaii's legislature passed and Governor Lingle signed major tax cut legislation (Act 110). The bill included two major income tax provisions which together cost about $49 million per year, according to the state tax department: one that raised Hawaii's standard deductions to 40 percent of the federal level, and one that raised the tax bracket breakpoints.

The proponents of Act 110 justified its large cost, in part, by arguing that it would make a big difference for low-income working families. But the improvements were rather small. For instance, if the act were fully phased in in 2006, a typical family of three with income at the poverty line would see its tax liability decline from $373 in 2005 to $294 in 2006, a cut of just $79. (This assumes the family's income increased with inflation between 2005 and 2006.)

The reason that the costly bill did not help poor families more is that most of the benefit went to middle and upper-income families. The Institute on Taxation and Economic Policy calculates that only five percent of the tax cut's overall cost went to the poorest 20 percent of Hawaii taxpayers, and just 20 percent went to the poorest 40 percent.[4]

Hawaii Continues to Impose One of the Heaviest Income Tax Burdens in the Nation On Low-Income Families

Like Hawaii, most of the states that levied high income taxes on the poor in 2005 enacted income tax cuts during the 2006 legislative sessions. But the others generally did a better job of targeting

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[2] Jason A. Levitis and Nicholas Johnson, "The Impact of State Income Taxes on Low-Income Families in 2005," Center on Budget and Policy Priorities, February, 2006. Available at www.cbpp.org/2-22-06sfp.htm.

[3] See Jason A. Levitis and Nicholas Johnson, "A dubious honor for Hawaii: Legislative action in Alabama moves Hawaii's income tax to the top in taxing poor working families," Center on Budget and Policy Priorities, April, 2006. Available at www.cbpp.org/4-17-06sfp.htm.

[4] For an analysis of Act 110 (then referred to as HB957) based on Tax Year 2005 law, see Jason A. Levitis and Nicholas Johnson, "The Impact of Hawaii's Income Tax on Low-Income Families: An Update." Available at www.cbpp.org/5-4-06sfp2.htm.

Table 1. 2005 and Current Rankings of Income Tax Liability at the Poverty Line for One-Parent Families of Three — Ten States With Highest Tax Burden							
2005				Current Law*			
Rank	State	Income	Tax	Rank	State	Income	Tax
1	Alabama	$15,577	$458	**1**	**Hawaii**	**$16,122**	**$294**
2	**Hawaii**	**15,577**	**373**	2	Alabama	16,122	283
3	West Virginia	15,577	287	3	Louisiana	16,122	150
4	Michigan	15,577	186	4	Montana	16,122	143
5	Louisiana	15,577	155	5	Arkansas	16,122	137
6	Montana	15,577	143	6	Georgia	16,122	101
7	Arkansas	15,577	126	7	Ohio	16,122	94
8	Oregon	15,577	117	8	Illinois	16,122	91
9	Ohio	15,577	90	9	Indiana	16,122	89
10	Georgia	15,577	82	10	Oregon	16,122	78

Source: Center on Budget and Policy Priorities

*Reflects tax year 2006 if legislated changes affecting future years were in effect.

benefits to low-income families than Hawaii did. Low-income working families in Alabama, Michigan, and West Virginia, for instance, received tax cuts worth several hundred dollars each.

Despite cutting taxes, therefore, Hawaii's *ranking* in its treatment of the working poor actually has worsened in the last year. For example, Table 1 shows that under current law (meaning 2006 tax law if Act 110 and other expected tax changes were fully phased in), Hawaii levies the highest income tax on one-parent families of three at the poverty line — almost $300.[5] By comparison, in 2005 Hawaii levied the second-largest tax (after Alabama) on such families.

Table 2 shows Hawaii's rankings in a number of measures of income tax burden on low-income families. These are measures by which the Center on Budget and Policy Priorities has ranked state income tax codes every year since 1990. By every measure, Hawaii's income tax now ranks among the four most burdensome in the nation.

- As noted above, Hawaii levies the highest tax in the nation — $294 — on one-parent families of three at the poverty line.
- Hawaii also levies the highest tax — $546 — on one-parent families of three just above poverty — those earning 125 percent the federal poverty line.
- Hawaii's income tax on two-parent families of four at the poverty line is the third highest in the nation — at $546.
- Hawaii's tax thresholds — the level of income at which families first must pay income tax — are third lowest in the country for both three- and four-person families. The thresholds remain thousands of dollars below the poverty lines for these families.

[5] Here and throughout this report, the poverty line refers to a CBPP estimate of the Census Bureau's preliminary weighted average poverty line for 2006.

Table 2. Hawaii's Rankings in Measures of Income Tax Burden on Low-Income Families			
Measure of Tax Burden	Amount*	Hawaii's Rank under Current Law* (out of 42)	Hawaii's Rank in 2005 (out of 42)
Income Tax at the Federal Poverty Line for:			
One-Parent Families of Three (income = $16,122)	$294	**1**	2
Two-Parent Families of Four (income = $20,670)	382	**3**	2
Income Tax at 125% of the Federal Poverty Line for:			
One-Parent Families of Three (income = $20,153)	546	**1**	2
Two-Parent Families of Four (income = $25,838)	665	**4**	3
Income Tax Threshold for:			
One-Parent Families of Three	10,400	**3**	3
Two-Parent Families of Four	14,000	**3**	4

Source: Center on Budget and Policy Priorities
*Reflects tax year 2006 if legislated changes affecting future years were in effect.

Thus, despite Act 110, Hawaii continues to charge poor families hundreds of dollars in income tax, and to collect income tax even from families in severe poverty.

Why Low-Income Tax Relief Matters

Taxing the incomes of working-poor families runs counter to the efforts of policymakers across the political spectrum to help families work their way out of poverty. The federal government has exempted such families from the income tax since the mid-1980s, and a majority of states now do so as well.

Hawaii's high cost of living makes high taxes on the poor especially troubling. For a family struggling to escape poverty, a few hundred dollars is a lot of money. And Hawaii's low-income families pay not only income taxes but also significant amounts of sales taxes and property taxes.

Low-income tax relief is also important for fairness. Hawaii's tax system is regressive: low-income residents pay a higher share of their income in taxes than do wealthier residents.[6] Reducing the income taxes paid by the low-income families can moderate this imbalance.

A State Earned Income Tax Credit Would Bring Meaningful Tax Relief to Hawaii's Low-Income Families at Moderate Cost

As Hawaii's 2007 legislative session begins, the legislature is considering two primary proposals to provide low-income tax relief. The governor has proposed a package of tax cuts that includes an additional expansion of the standard deduction, a new income exemption for dependents, and

[6] Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in all 50 States, 2nd Ed."

Table 3. Comparison of Governor's Income Tax Proposal and a 20% EITC: Cost to the State and Impact on Low-Income Families			
Measure of Cost or Tax Burden	**Current Law**	**Governor's Proposal**	**20% EITC**
Cost in 2007 (millions)	0	$60	$24
Bills	None	SB1493, SB1494, SB1495	HB1799/ SB1919
Income Tax at the Federal Poverty Line for:			
One-Parent Families of Three (income = $16,122)	$294	$82	-$558
Two-Parent Families of Four (income = $20,670)	382	138	-363
Income Tax at 125% of the Federal Poverty Line for:			
One-Parent Families of Three (income = $20,153)	546	296	-135
Two-Parent Families of Four (income = $25,838)	665	362	138
Income Tax Threshold for:			
One-Parent Families of Three	10,400	15,000	21,500
Two-Parent Families of Four	14,000	16,600	24,400

Source: Center on Budget and Policy Priorities

All calculations reflect tax year 2006 as if changes affecting future years were in effect.

indexing of income tax parameters. (The Governor also proposes other tax changes not considered here.) Legislative leaders from both the House and the Senate are supporting bills that would enact a state Earned Income Tax Credit. While both approaches provide significant tax relief to low-income families, an EITC would provide greater benefit at less cost than the governor's plan. Table 3 shows the cost and impact of each proposal and compares them to current law.

The Governor's Plan

Governor Lingle's State of the State address on January 22 included three proposals that would permanently reduce the income tax in Hawaii, at a combined cost of about $60 million in 2007.[7] The first is an increase in Hawaii's standard deduction to 75 percent of the 2005 federal standard deduction, at an estimated cost of $30 million per year.[8] The second would create a new income tax exemption for dependents in families with income up to $100,000 per year, at an estimated cost of about $20 million.[9] Finally, the governor proposes that income exemptions, standard deductions, and tax brackets be indexed for inflation (that is, automatically adjusted each year to reflect changes in prices) at a cost of $10 million.[10]

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[7] This paper considers only the permanent tax-cut provisions of the Governor's proposal. The governor has also proposed a one-time tax rebate and a number of exclusions to the General Excise Tax. Including these provisions, the Governor estimates her proposal would cost $346 million in fiscal year 2008.

[8] See SB1493.

[9] See SB1495. The exemption would be $1,000 per dependent for families with income up to $50,000 and $500 per exemption for families between $50,000 and $100,000. SB1495 also includes an increase in the maximum allowable child care tax credit. The cost estimate of $20 million is based estimated cost of SB1495 ($25.9 million) and the latest available cost estimate for the child care credit ($8 million) as reported in "Tax Credits Claimed by Hawaii Taxpayers, 2003," Hawaii Dept. of Taxation.

[10] See SB1494.

The governor's proposal would reduce income taxes on low-income families, but not enough to bring Hawaii into the mainstream of states that exempt the poor from income taxes. For a two-parent family of four, the income tax threshold would increase from $14,000 to $16,600, still well below the poverty line of $20,670.[11] And poor and near-poor families would continue to owe significant income taxes. Hawaii would still rank among the harshest few states in every measure of income tax burden on the poor.

An Earned Income Tax Credit for Hawaii

A number of legislators have introduced bills to enact EITCs. Two leading proposals are HB1799, which has the support of House leadership, and SB1919, an omnibus asset-building package introduced by the Senate leadership. Both bills would create a refundable EITC set at 20 percent of the federal EITC, which the tax department estimates would cost $24 million in 2007.[12] A state EITC is automatically indexed for inflation, so like the Governor's proposal it would keep pace with the ever-growing cost of living.

A 20 percent EITC would make a major improvement in Hawaii's income tax treatment of low-income families. The state's threshold would rise to $21,500 for families of three and $24,400 for families of four — in both cases well above the poverty line. Families with poverty-level income would no longer owe income tax and instead would receive refunds of several hundred dollars, partially offsetting the other state taxes they pay. Overall, Hawaii's income tax would move from being one of the most burdensome on low-income families to being one of the ten most generous — a status in keeping with Hawaii's high cost of living.

An EITC Would Provide Greater Help to the Families Who Need It Most at Lower Cost than the Governor's Plan

Both the governor's proposal and a state EITC would improve Hawaii's income tax treatment of low-to-moderate-income working families. But a state EITC would do more for these families and at lower cost. The governor's income tax proposals would cost about $60 million per year and yet would leave Hawaii among the worst few states in every measure of income tax burden on low-income families. An EITC set at 20 percent of the federal would cost less than half as much — about $24 million per year — and would exempt poor working families in Hawaii from the income tax and instead provide them with a modest refund to help offset other taxes.

The reason for the difference is targeting — an EITC is specifically designed to benefit families that need it most: low- and moderate-income working families, primarily those with children. The benefits of the governor's proposal are distributed more broadly. Since low-income families currently bear an unusual income-tax burden in Hawaii, it is appropriate that tax relief be targeted to them.

[11] All impact estimates in this report are based on the effect proposals would have were they in effect in 2006. Since both the Governor's proposal and the state EITC are indexed for inflation, each would keep pace with inflation over time.

[12] For information on the structure and workings of an EITC, see the Appendix to this report.

Appendix: About state Earned Income Tax Credits

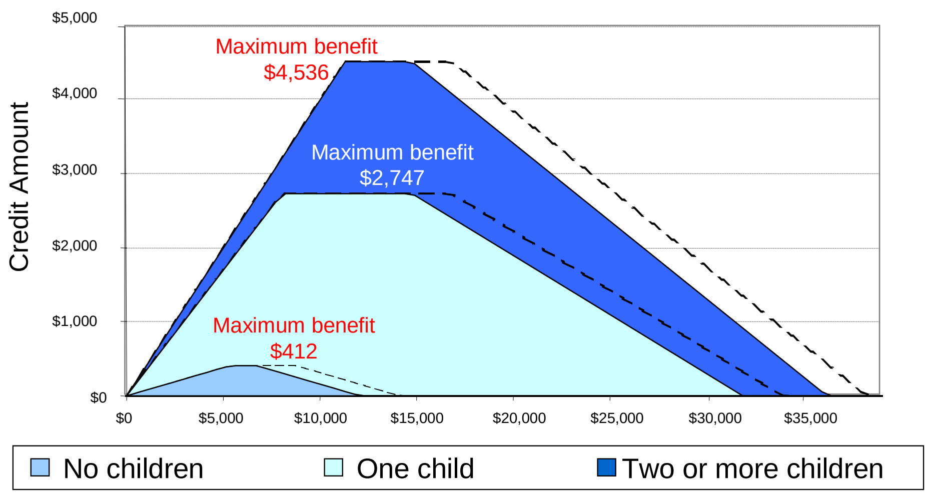
What is a State EITC?

An Earned Income Tax Credit is a tax rebate and wage supplement for low-to-moderate income working families. State EITCs are generally based on the federal EITC; the amount of a state EITC is typically set as a percentage of the federal credit — anywhere from 5 percent to 50 percent. The credit primarily benefits families with dependent children, though a much smaller credit is available to childless adults.

The benefit a family receives from the EITC depends on the composition of the family (number of adults and children) and on the family's earning. Figure 1 illustrates the structure of the federal EITC for tax year 2006. For families with very low earnings, the value of the EITC increases at a fixed matching rate as earnings rise. For example, a family with two or more children earning less than $11,340 receives an EITC equal to 40 cents for each dollar earned. Above this phase-in range, the EITC holds steady for a while at its maximum level, which is $4,536 for a family with two or more children. The credit then gradually phases out, beginning at $16,810 for married couples with children and continuing up to $38,348 for two-parent families with two or more children. Because the phase-out is gradual, families do not face the sudden loss of benefits that can create a disincentive to work.

FIGURE 1

The Federal Earned Income Tax Credit in Tax Year 2006



Note: Married couples with income in the phaseout range qualify for a higher credit than single parents — shown by dashed lines.

Why are State EITCs popular?

The Earned Income Tax Credit is one of the most popular and successful tools for helping needy families. Championed by President Reagan and expanded under every president since, the federal EITC is credited with lifting millions of people out of poverty each year. State EITCs — 20 in all — have been enacted in states led by Republicans, in states led by Democrats, and in states with bipartisan leadership.[13] At least ten states are seriously considering enacting or expanding EITCs this year.

The reasons for the EITC's popularity extend beyond its targeting and affordability. They include:

- ***A state EITC rewards and encourages work.*** The EITC is available only to working families, and it increases as income increases for families entering the workforce. As a result, the EITC creates a strong incentive to work. Extensive research has shown it increases workforce participation among eligible families.[14]

- ***A state EITC reduces child poverty and economic hardship.*** In 2004, some 8.8 million children in working families in America lived in poverty. And many families with incomes above the official poverty line also face significant difficulty in meeting the costs of food, housing, transportation, clothing, and other necessities — especially in high-cost states like Hawaii. A state EITC would reduce poverty and hardship among families with children. It is worth noting that an EITC goes beyond reducing income tax liability. It provides a refund to the poorest working families, helping offset the other taxes that they pay.

- ***The state EITC is easy to administer.*** Since they are administered through the tax code and rely on information included in income tax forms, EITCs are easier to administer than other programs aimed at the poor. And the administrative cost to a state for an EITC is even lower than for the federal government, because the Internal Revenue Service does much of the work. The federal government uses mechanisms such as large databases of Social Security numbers to screen for ineligible EITC applicants and reject their claims. States, in effect, piggyback on these federal enforcement mechanisms.

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[13] For more information on other state's EITCs, see Ifie Okwuje and Nicholas Johnson, "A Rising Number of State Earned Income Tax Credits Are Helping Working Families Escape Poverty." Available at www.cbpp.org/10-12-06sfp.htm.

[14] For example: In a series of studies on the EITC, Harvard economist Jeffrey Liebman noted that workforce participation among single women with children has risen dramatically since the mid-1980s, while there was no increase in work effort among single women without children. Studies by Liebman and University of California economist Nada Eissa find a sizable EITC effect in inducing more single women with children to work. A study by Northwestern University economists Bruce Meyer and Dan Rosenbaum finds that EITC expansions explain more than half of the increase in employment among single mothers over the 1984-1996 period. Of note, Meyer and Rosenbaum found evidence that state EITCs also contributed to workforce participation increases in the states where credits were available. A very recent study confirms a strong connection between the size of a family's EITC benefit and its likelihood of employment. Authors V. Joseph Holtz, Charles H. Mullin, and John Karl Scholz found that welfare-recipient families with two or more children experienced noticeably faster rates of employment growth than families with one child because the larger families were eligible for greater EITC payments.