Hawaii Tax System: Income Tax
Tax Review Commission

TAX RESEARCH & PLANNING, DOTAX

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JAN 20TH, 2021

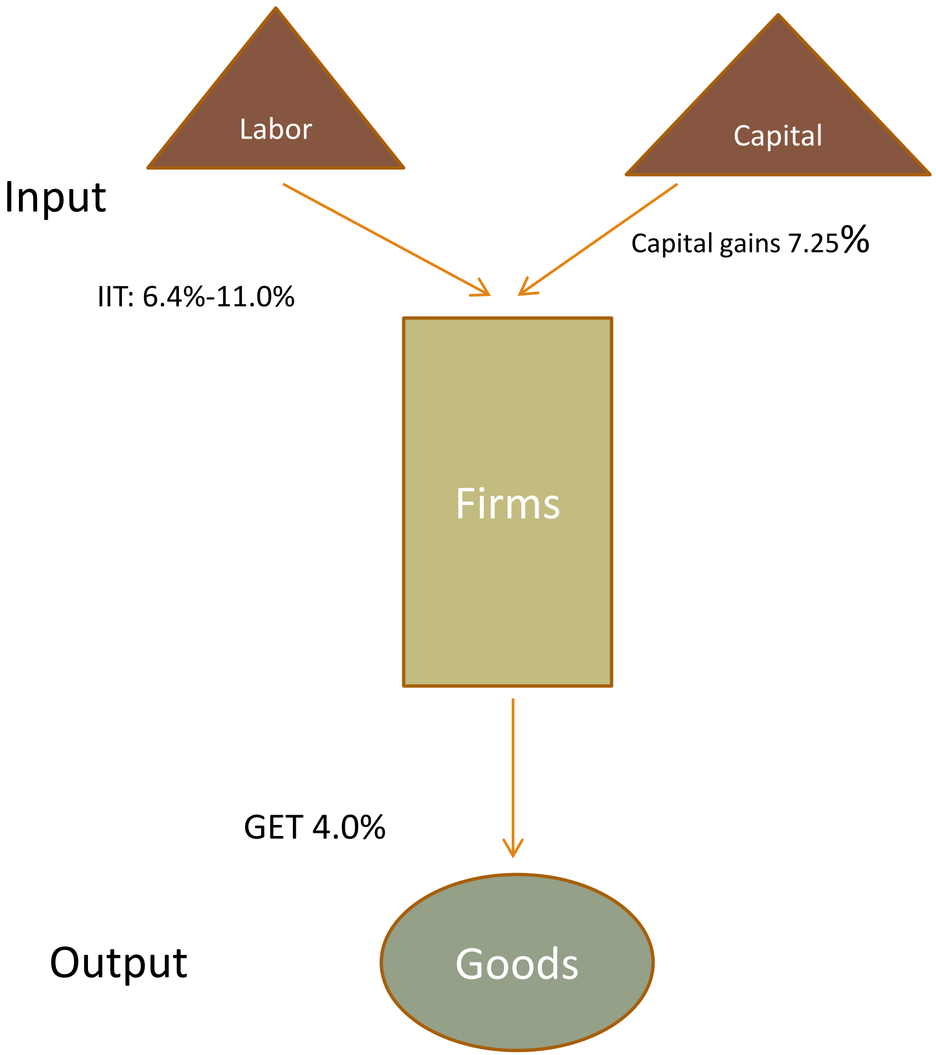
An income tax is a tax on an economic input

Taxes on outputs are less likely to distort economic behavior than taxes on inputs

- Labor and capital are inputs
- The is one rationale behind consumption taxes

Taxing income may lead to inefficient outcomes

- Taxing income discourages work. Less labor leads to a decline in economic output
- Income tax is a disincentive to save because income tax penalizes consumption and savings



Why do most governments tax labor inputs more than capital?

Capital is mobile whereas labor is more domiciled

Capital accumulation is strongly correlated with growth (promote investment)

Most governments tax capital (capital gains and corporate income) less than labor

However, labor more mobile between states than internationally, especially with the e-economy

What is the optimal rate of taxation?

Economic literature is divided on the optimal marginal rate of taxation

- Range is somewhere between 0 and 100%
- As income taxes get higher, more likely that people leave the work force or leave the tax jurisdiction

Consideration: as you raise income tax, people may substitute labor with capital

- Receive equity compensation (taxed at capital gains)
- Increase use of C and S corporations (Gordon and Slemrod '00)

There is a trade off between equity and efficiency

Income tax is favored for its ability to redistribute

Income tax allows authorities to apply different rates according "ability to pay"

Graduated tax schedules help reduce inequality

However,

Income is not wealth. Wealth inequality tends to be more severe than income inequality

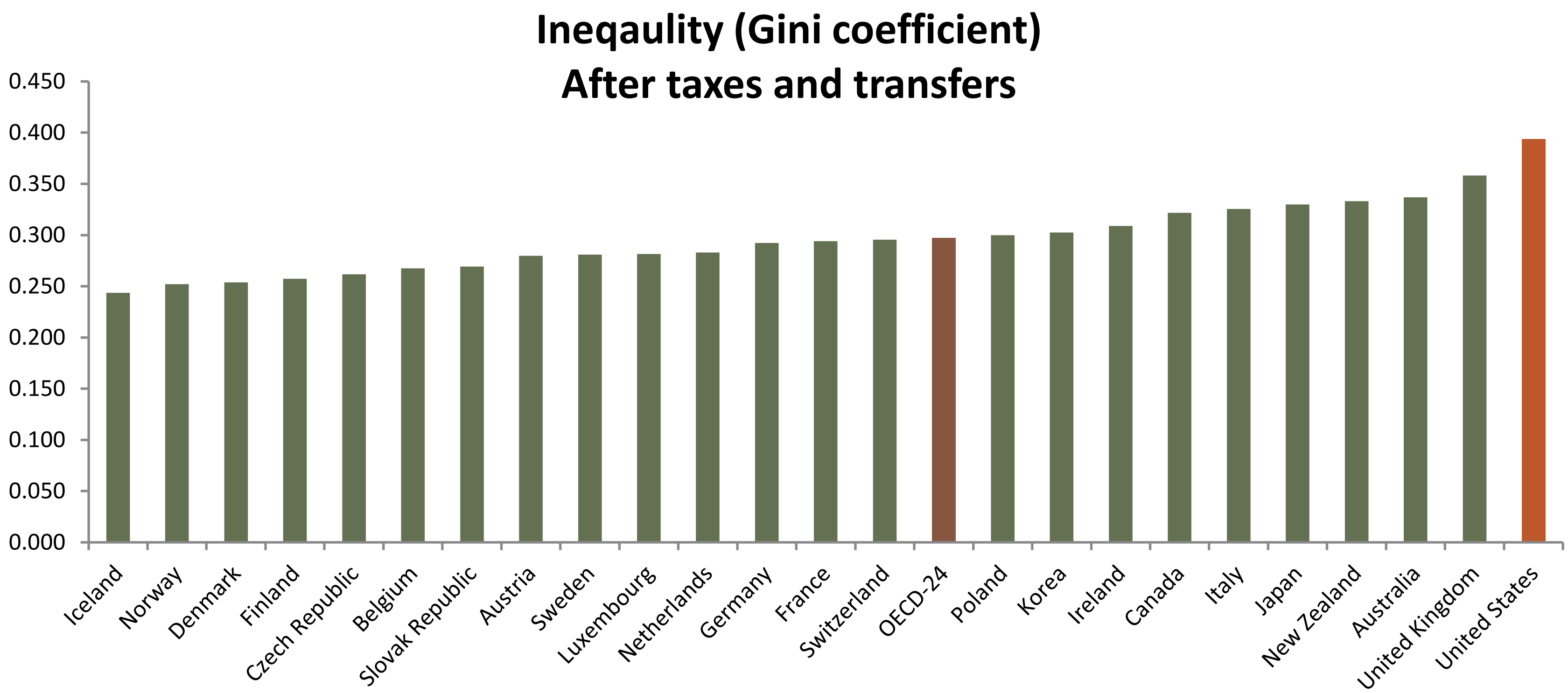
It is possible to "hide" income, especially for wealthy individuals that receive most of their income for capital and engage in tax planning

Income Tax vs. Consumption Tax

	Individual Income Tax	Consumption Tax
Equity	Tend to be more progressive (using graduated rates)	Regressive (less in life cycle terms)
Efficiency	Moderate to high: Taxation of input reduces work, depends a lot on rates. Discourages savings	Minimal: If applied equally to all consumption goods
Administrative Burden	Easy to moderate	Easy
Avoidance	Moderate to high	Low

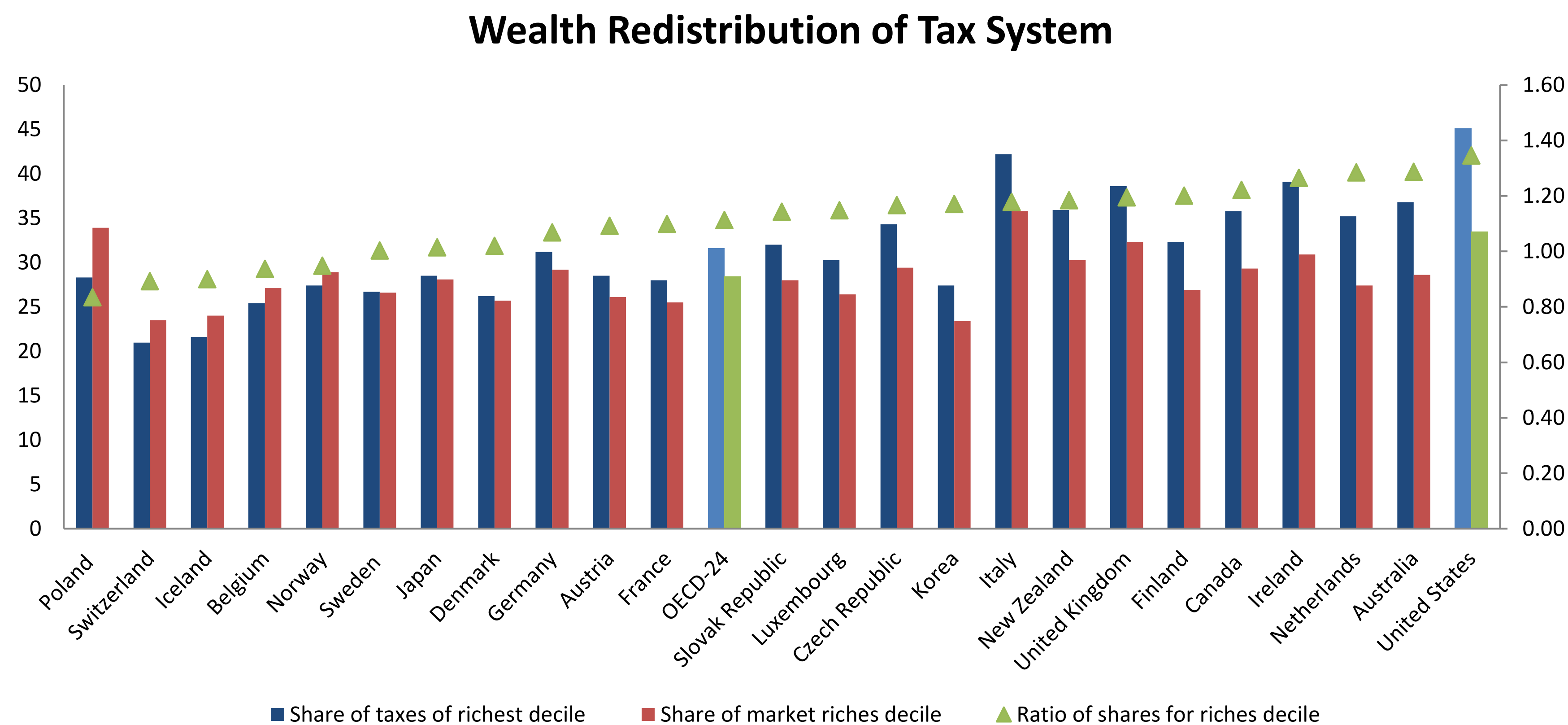
A digression on inequality in the US and Hawaii

The United States is one of the most unequal OECD countries



Source: OECD (2015) In it Together: Why Less Inequality Benefits All

The US has one of the most progressive tax systems in the OECD

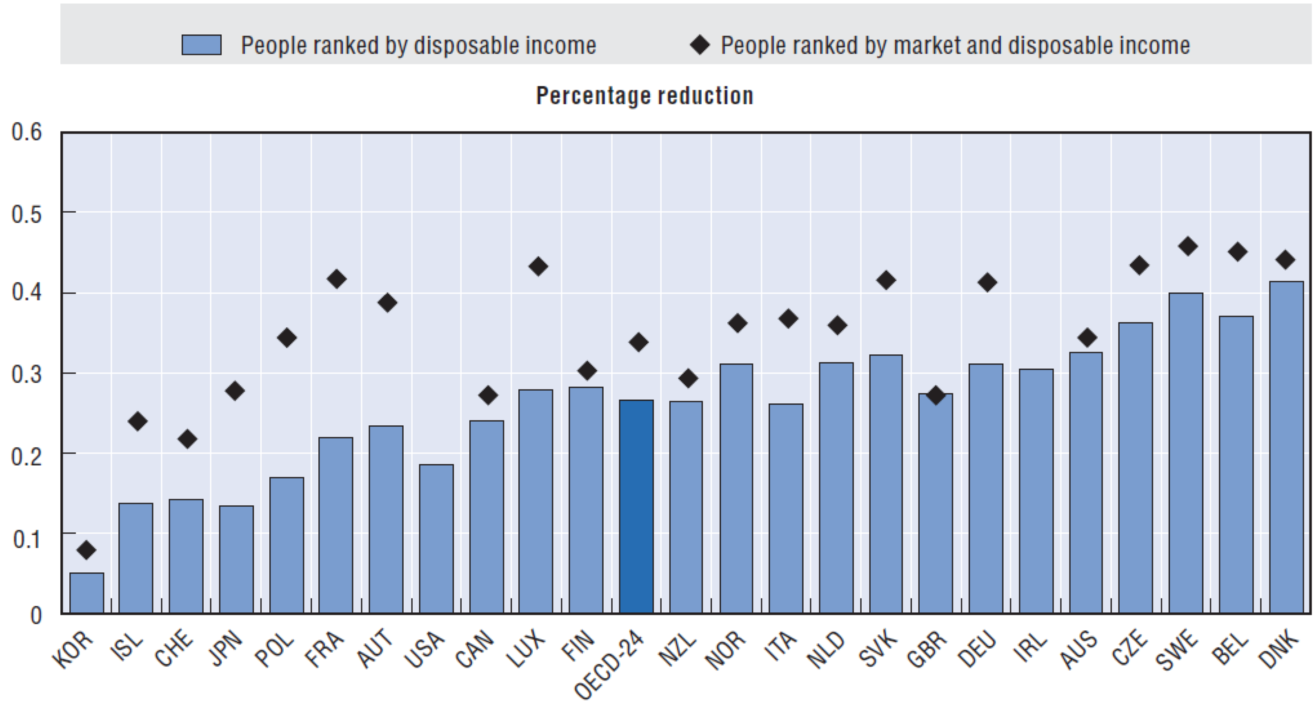


Source: OECD (2008) Growing Unequal? Income Distribution and Poverty in OECD countries

United States redistributes less than most other developed countries

Figure 4.4. **Differences in inequality before and after taxes and transfers in OECD countries**

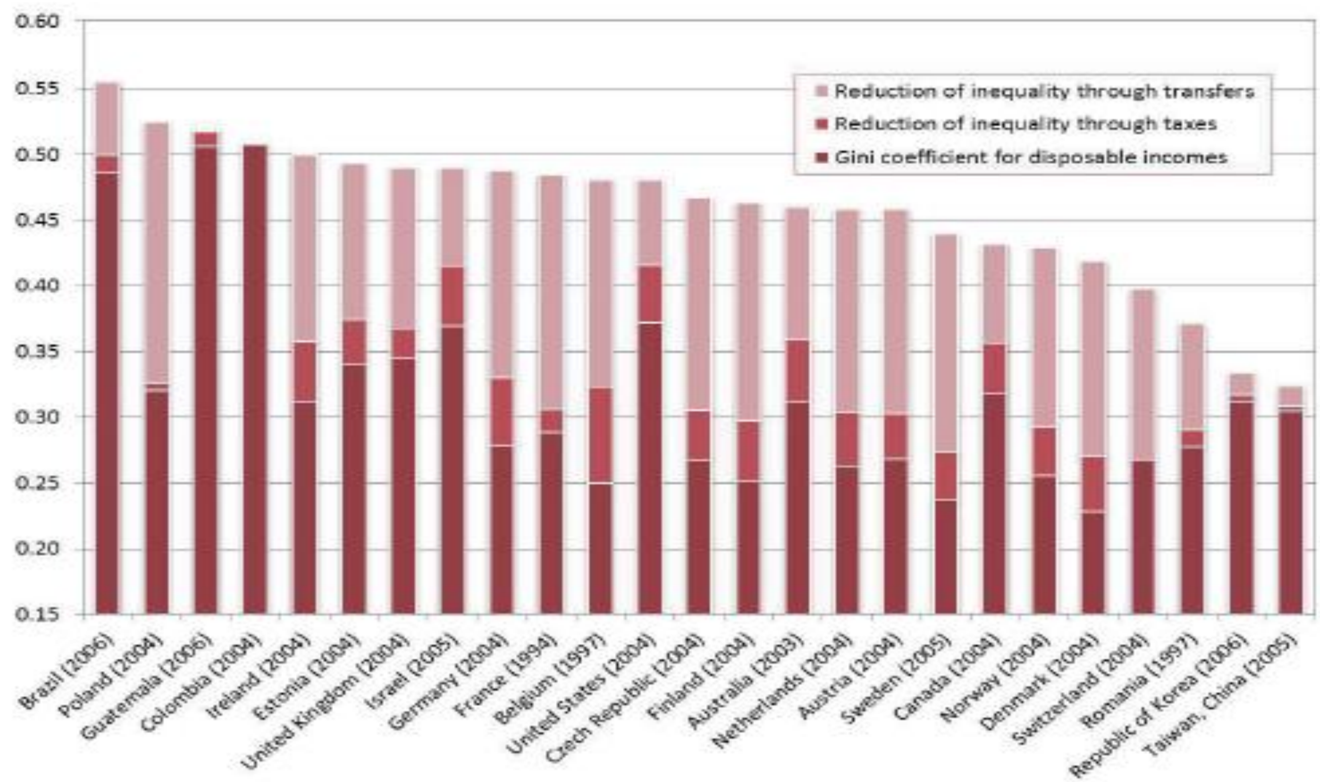
Difference in concentration coefficients around 2005



Source: OECD (2008) How much redistribution do governments achieve?

The US relies on taxes to redistribute, which is less effective than cash transfers

The impact of taxes and transfers on income inequality in 25 countries



Note: The total height of the column corresponds to the Gini coefficient for market incomes (i.e. before taxes and transfers).
Source: Luxembourg Income Study (LIS) Database, http://www.lisproject.org/techdoc.htm (multiple countries, analysis of micro-data).

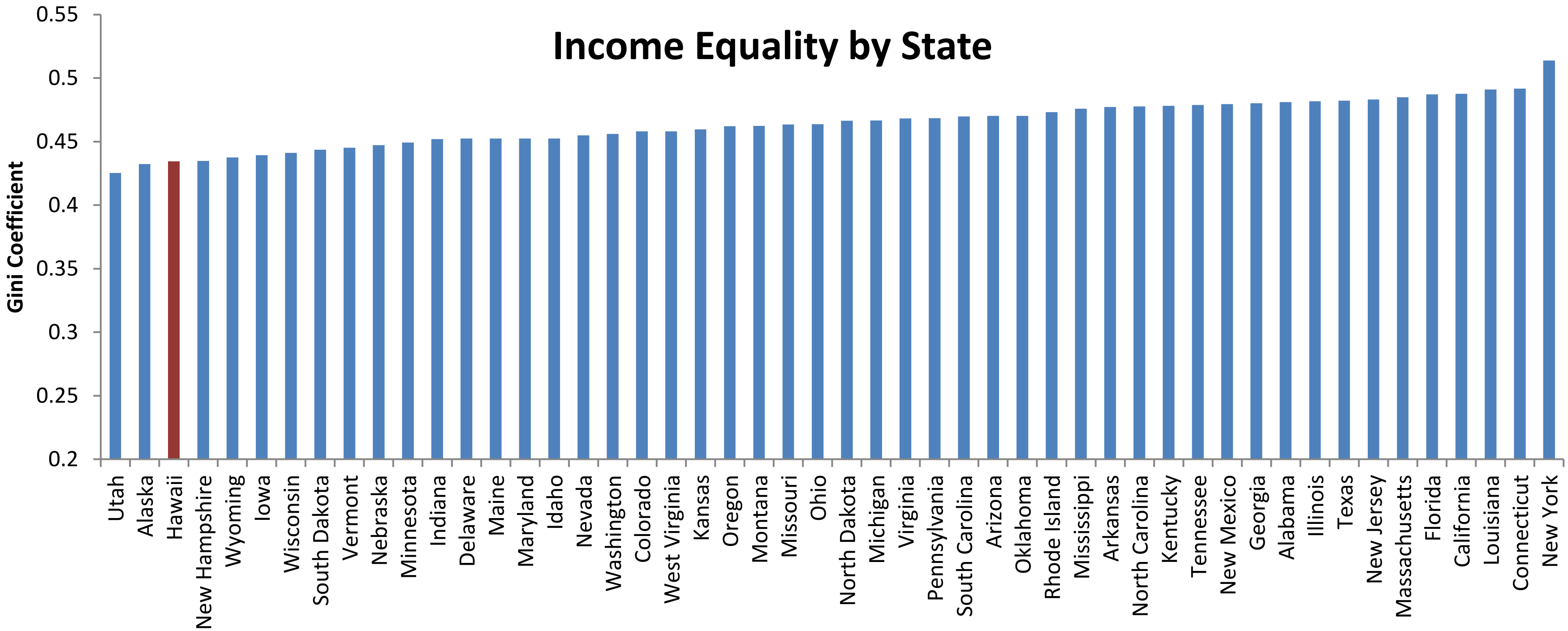
Hawaii is one of the most equal states in the country

Hawaii is the third most equal state in the country according to GINI Coefficient

Hawaii is the second most equal state based on the ration of top1% to bottom 99% of income

Global economic forces have led to outsized economic gains for top income earners since the 1970s but the gains have been less dramatic in Hawaii relative to other states.

- Hawaii: +54% Income change for top 1 percent of household since 1979. All others saw -9%
- New York: +273 Income change for top 1 percent of households since 1979. All others saw +5% increase



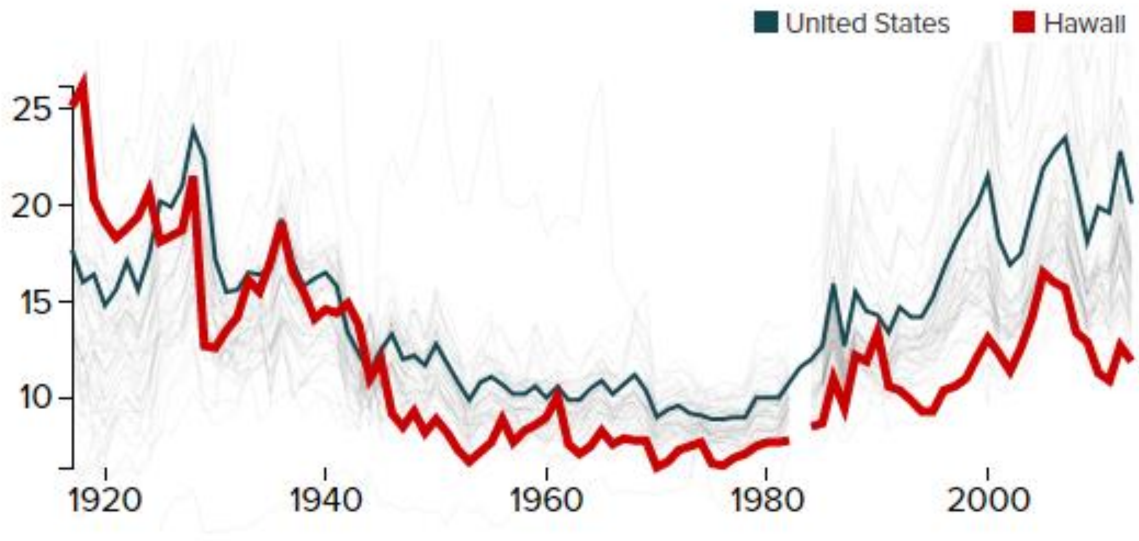
Source: American Community Survey (2015)

Includes all cash income

Income gains in the top 1% have been modest compared to other states

The top 1% takes home 11.9% of all the income in Hawaii, compared to an average of 20% In the US

Share of income captured by the top 1%, 1917-2012



Source: Economic Policy Institute

The median Hawaiian household reports above average income but residents in top 1.0% report below average income compared to other states

$80,108

Median HH income in Hawaii (5th highest in nation)

$140,990

Income threshold of top 10% of filers in Hawaii

Source: American Community Survey and DOTOX

Income threshold of top 1% of filers by state

Rank	State	Income threshold of top 1.0%	Share of Income earned by to 1.0%
1	Connecticut	$827,194	27%
2	Massachusetts	$728,272	23.7%
3	New York	$702,559	29.3%
4	New Jersey	$701,005	19.6%
5	California	$659,503	23.0%
6	Washington	$585,748	18.7%
7	Florida	$581,682	28.4%
Avg	United States	$538,926	28.4%
38	**Hawaii**	**$414,599**	**14.1%**

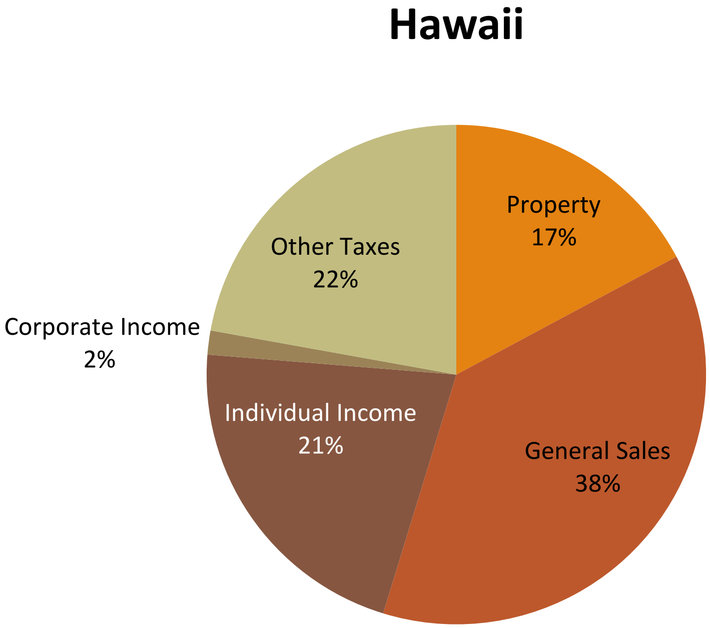
Source: IRS 2017

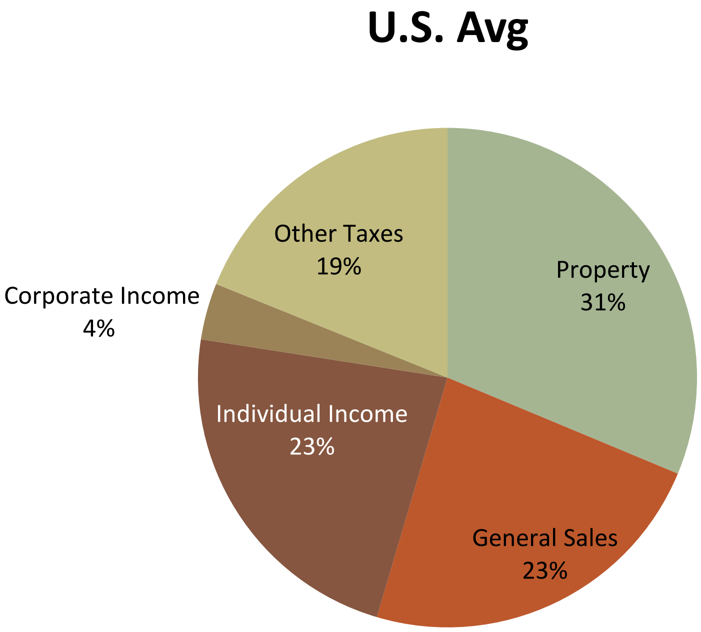
Hawaii's Individual Income Tax

At a Glance: Hawaii tax system

Hawaii revenue share of individual income tax is close to the national average

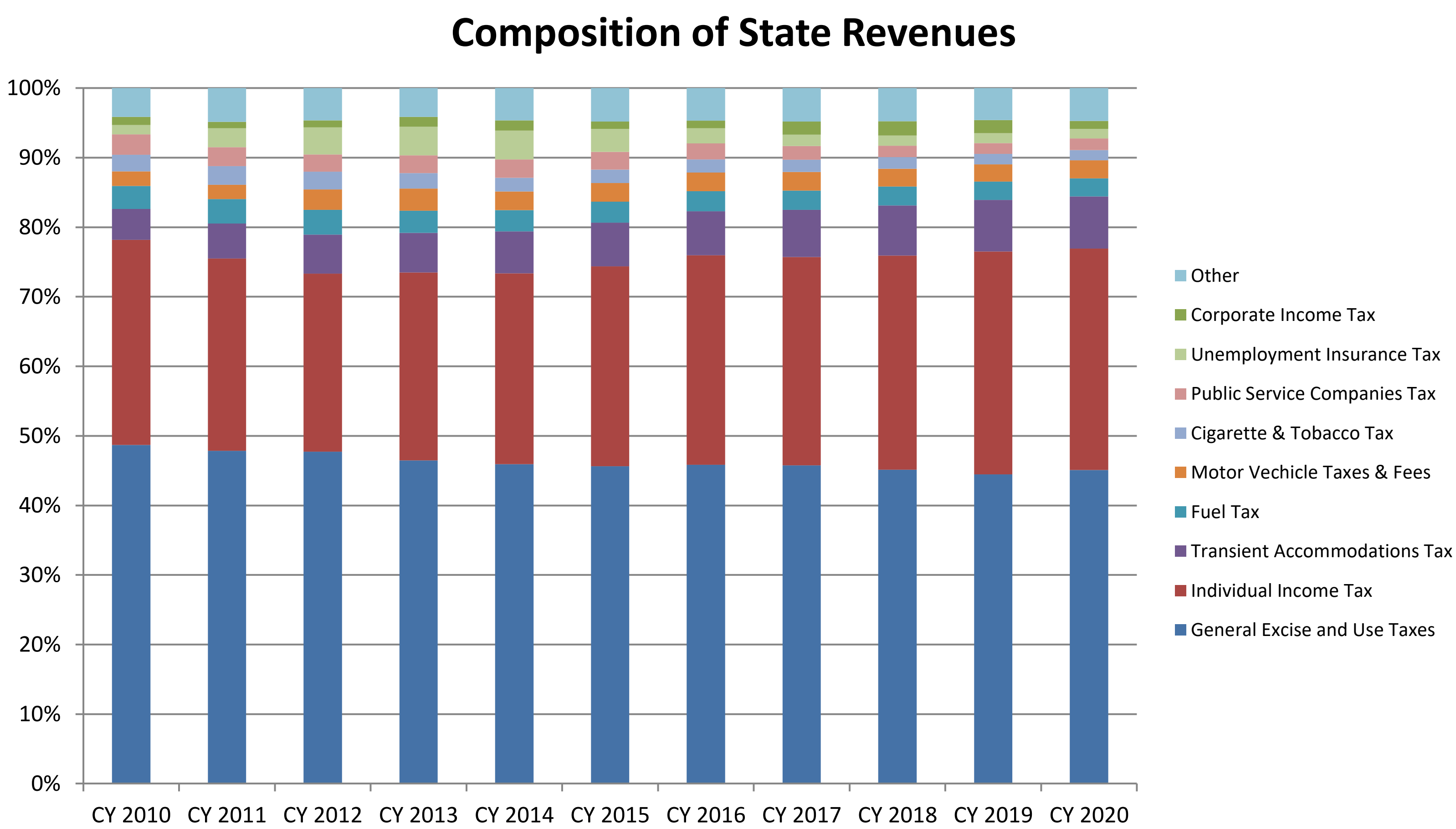
Composition of state and local taxes



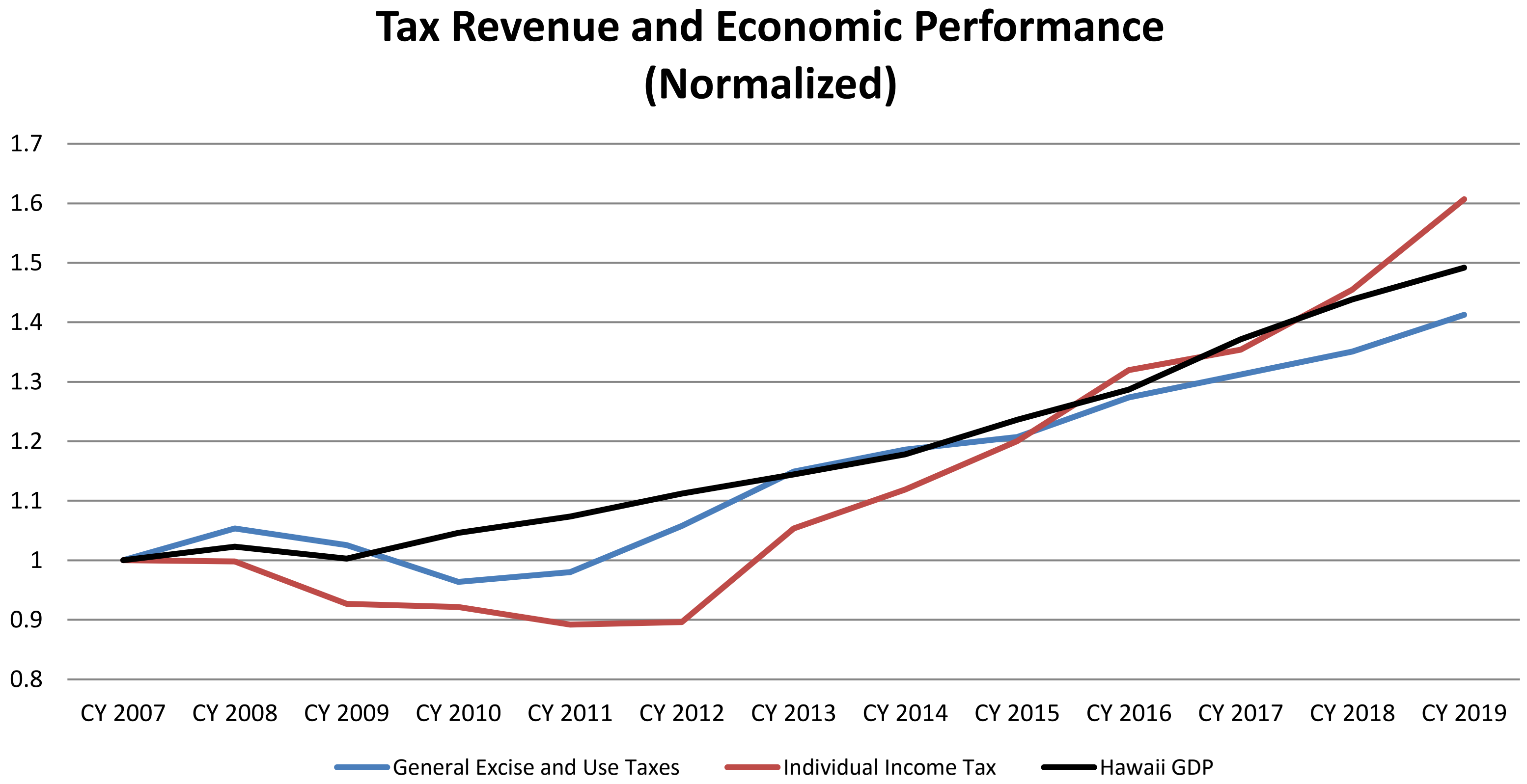


Source: Tax Foundation

Roughly 31% of total collections derive from individual income taxes



The GET is a more stable revenue source than the Individual Income Tax



Notable features of Hawaii individual income tax

Very progressive relative to other states

Many brackets

Brackets not indexed to inflation (unlike federal rates)

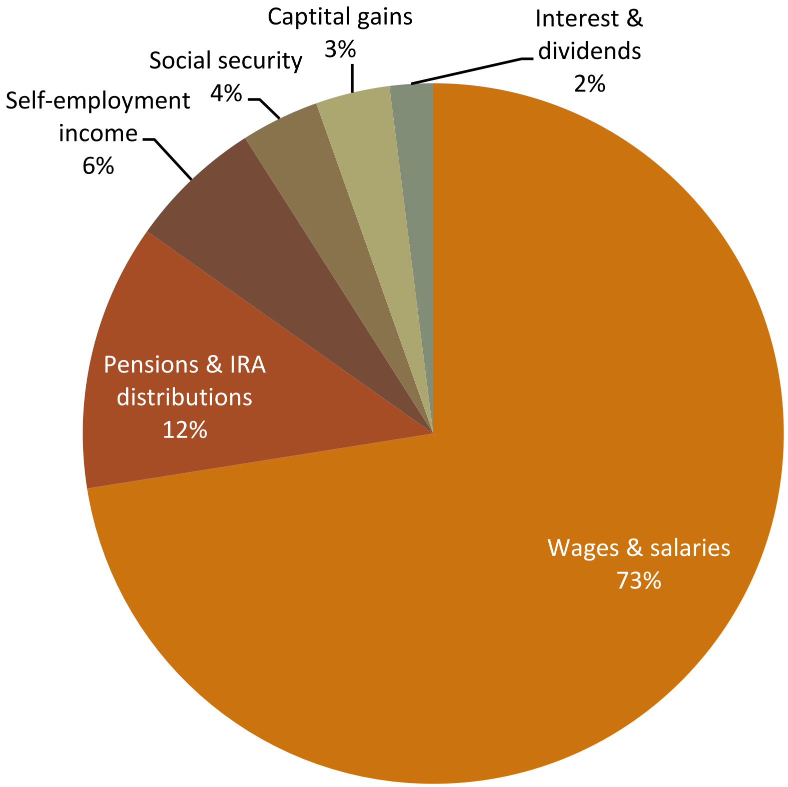
Relatively low standard exemption compared to federal (Federal $12,600, HI: $4,400)

Refundable credits offset burden for lower income individuals

The largest state specific exemption is pensions and social security, which is expected to grow with time

Hawaii exempts 16% of income through pension disbursements

Composition of federal Individual Income in Hawaii



Income Source	Rate
Wage & Salaries	Variable (See tax bracket)
Pensions & IRA distributions	0% (Employer contributions exempt)
Self-employment income	Variable (see tax bracket)
Social security	0%, (exempt)
Capital Gains	7.25%
Interest & Dividends	Variable (see tax bracket)

Hawaii has one of the highest marginal tax rates in the county

- 43 states levy individual incomes taxes
- 8 states have a single-rate structures
- Hawaii will have the most brackets in the country with 12. California and Missouri have the second most tax brackets with ten
- Hawaii has the second highest income tax rates of any state

	Highest Marginal Tax Bracket	
1	California	13.30%
2	Hawaii*	11.00%
3	Maine	10.15%
4	Oregon	9.90%
5	Minnesota	9.85%
6	Iowa	8.98%
7	New Jersey	8.97%
8	Vermont	8.95%
9	DC	8.95%
10	New York	8.82%
11	Wisconsin	7.65%
12	Idaho	7.40%

Hawaii income brackets are steep on the extremes and relatively flat in the middle

Tax brackets for Selected States
(Joint Filers)

Colorado
4.63% of federal taxable income

Virginia		
2.00%	>	$0
3.00%	>	$3,000
5.00%	>	$5,000
5.75%	>	$17,000

Maryland		
2.00%	>	$0
3.00%	>	$1,000
4.00%	>	$2,000
4.75%	>	$3,000
5.00%	>	$150,000
5.25%	>	$175,000
5.50%	>	$225,000
5.75%	>	$300,000

California		
1.00%	>	$0
2.00%	>	$16,030
4.00%	>	$38,002
6.00%	>	$59,978
8.00%	>	$83,258
9.30%	>	$105,224
10.30%	>	$537,500
11.30%	>	$644,998
12.30%	>	$1,074,996
13.30%	>	$1,074,996

Hawaii*		
1.40%	>	$0
3.20%	>	$4,800
5.50%	>	$9,600
6.40%	>	$19,200
6.80%	>	$28,800
7.20%	>	$38,400
7.60%	>	$48,000
7.90%	>	$72,000
8.25%	>	$96,000
9.00%	>	$300,000
10.00%	>	$350,000
11.00%	>	$400,000

Hawaii's tax brackets are more progressive than most states

Rates on Taxable Income for selected states (married, filed jointly)

Adjusted Gross Income	**50,000**		**75,000**		**100,000**		**150,000**		**350,000**		**Ratio**
	Marginal	Effective	Marginal	Effective	Marginal	Effective	Marginal	Effective	Marginal	Effective	350,000/ 50,000
Hawaii	7.60%	5.72%	7.90%	6.36%	8.25%	6.76%	8.25%	7.25%	8.25%	7.82%	137%
California	4.00%	2.16%	6.00%	3.17%	8.00%	4.21%	9.30%	5.86%	9.30%	7.83%	363%
Maryland	4.75%	4.64%	4.75%	4.68%	4.75%	4.70%	5.00%	4.71%	5.50%	5.13%	110%
Colorado	4.63%	4.63%	4.63%	4.63%	4.63%	4.63%	4.63%	4.63%	4.63%	4.63%	100%
Virginia	5.75%	5.23%	5.75%	5.41%	5.75%	5.49%	5.75%	5.58%	5.75%	5.68%	109%

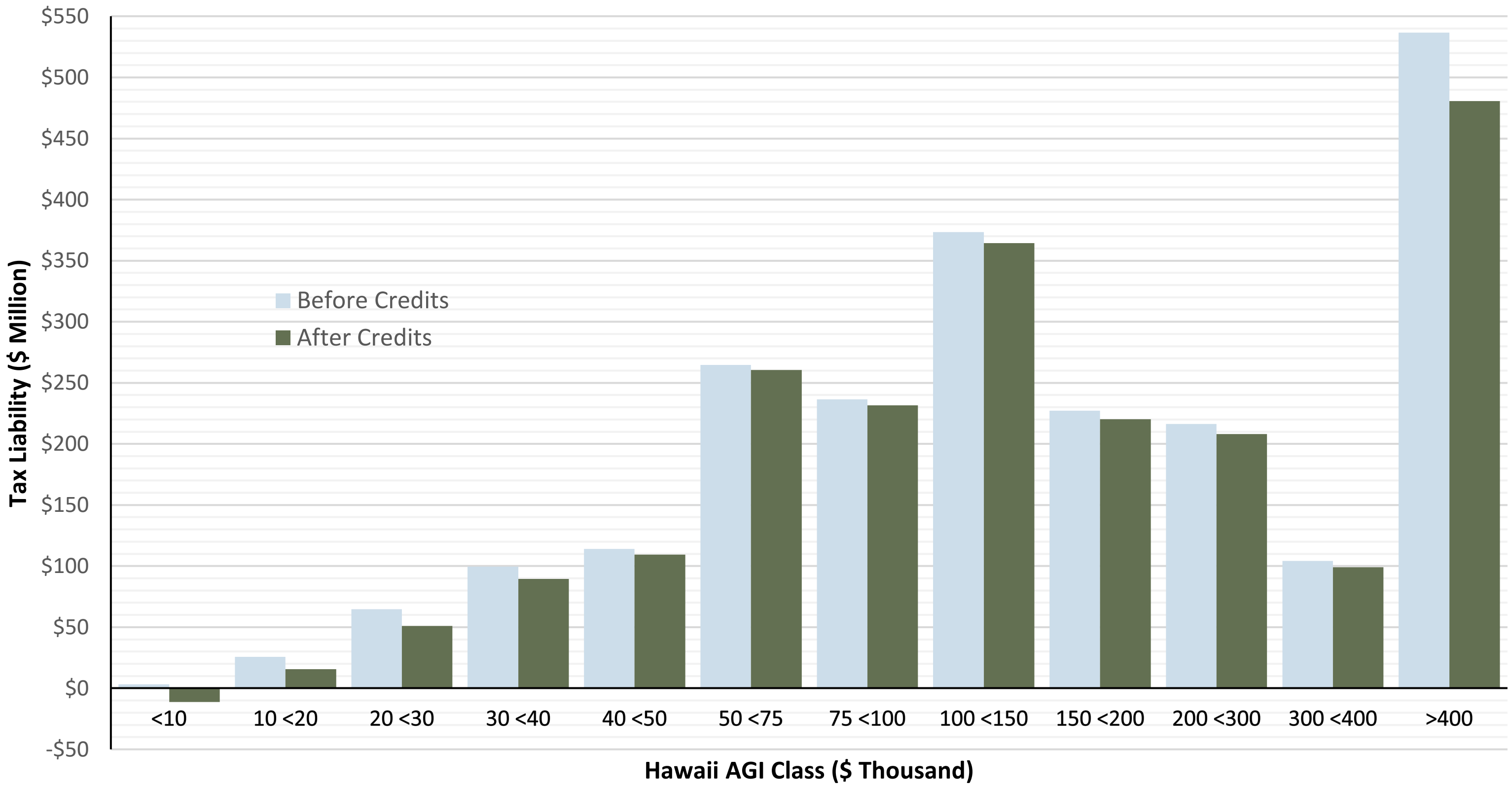
Year 2018
Using standard deduction and no dependents

Most resident filers are in middle and upper-middle tax brackets

2018 Joint Filers by tax brackets (residents)

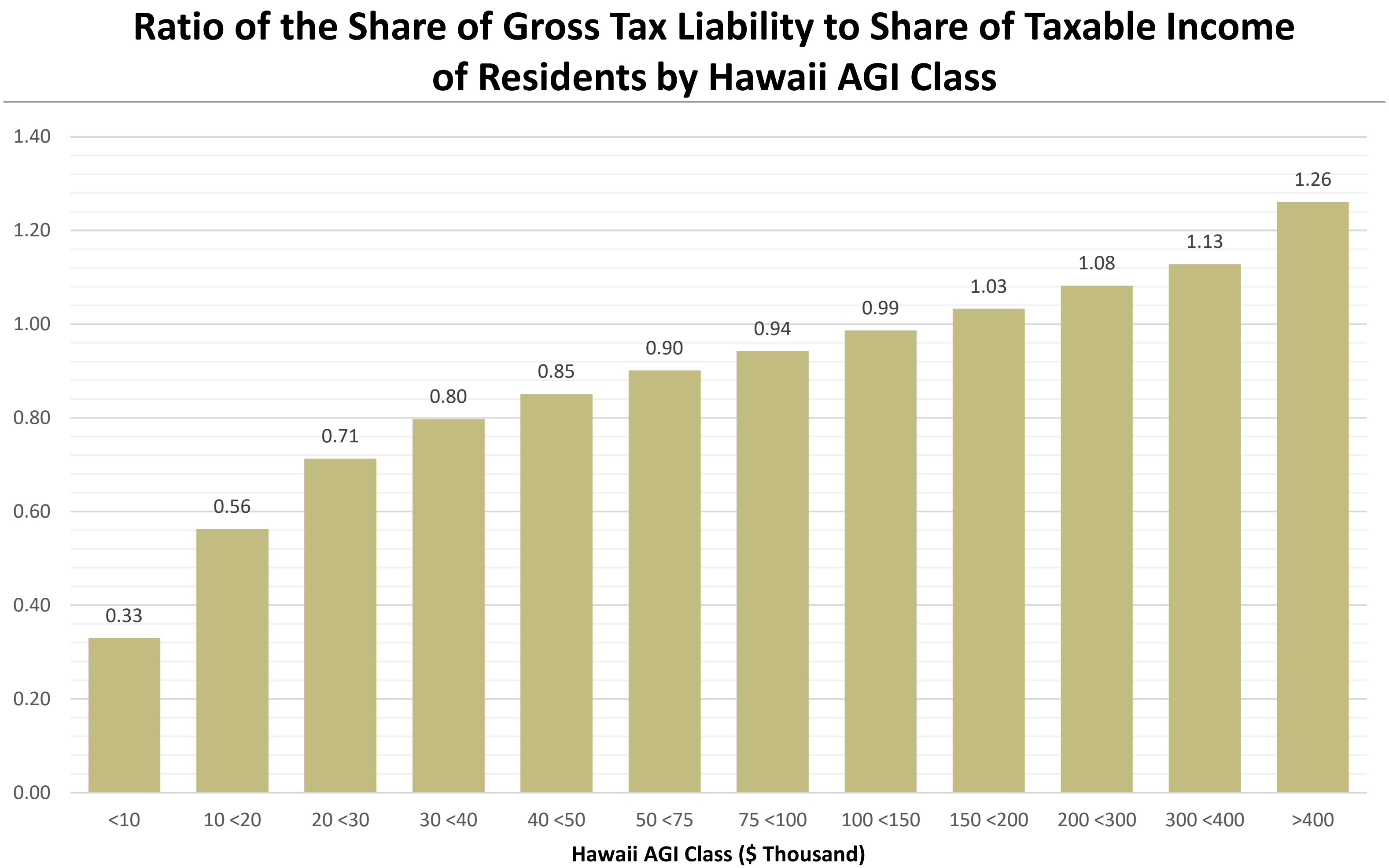
				Returns with Taxable Income in the Tax Bracket		
Tax Bracket (by Taxable Income)			Marginal Tax	Number of Returns	% of Total No. of Joint Returns	Amount of Taxable Income
$0	to	$4,800	1.40%	39,534	17.75%	$15,808,333
$4,801	to	$9,600	3.20%	6,473	2.91%	$46,624,377
$9,601	to	$19,200	5.50%	13,484	6.06%	$194,770,639
$19,201	to	$28,800	6.40%	14,073	6.32%	$338,011,998
$28,801	to	$38,400	6.80%	13,861	6.22%	$464,810,868
$38,401	to	$48,000	7.20%	13,498	6.06%	$582,493,413
$48,001	to	$72,000	7.60%	33,754	15.16%	$2,024,126,504
$72,001	to	$96,000	7.90%	29,027	13.04%	$2,422,020,698
$96,001	to	$300,000	8.25%	52,086	23.39%	$7,628,200,519
$300,001	to	$350,000	9.00%	1,616	0.73%	$522,070,010
$350,001	to	$400,000	10.00%	1,120	0.50%	$418,017,532
$400,001	&	Over	11.00%	4,155	1.87%	$4,656,684,945
ALL				222,681	100.00%	$19,313,639,836

Tax liability is skewed to the center and upper end of the income distribution



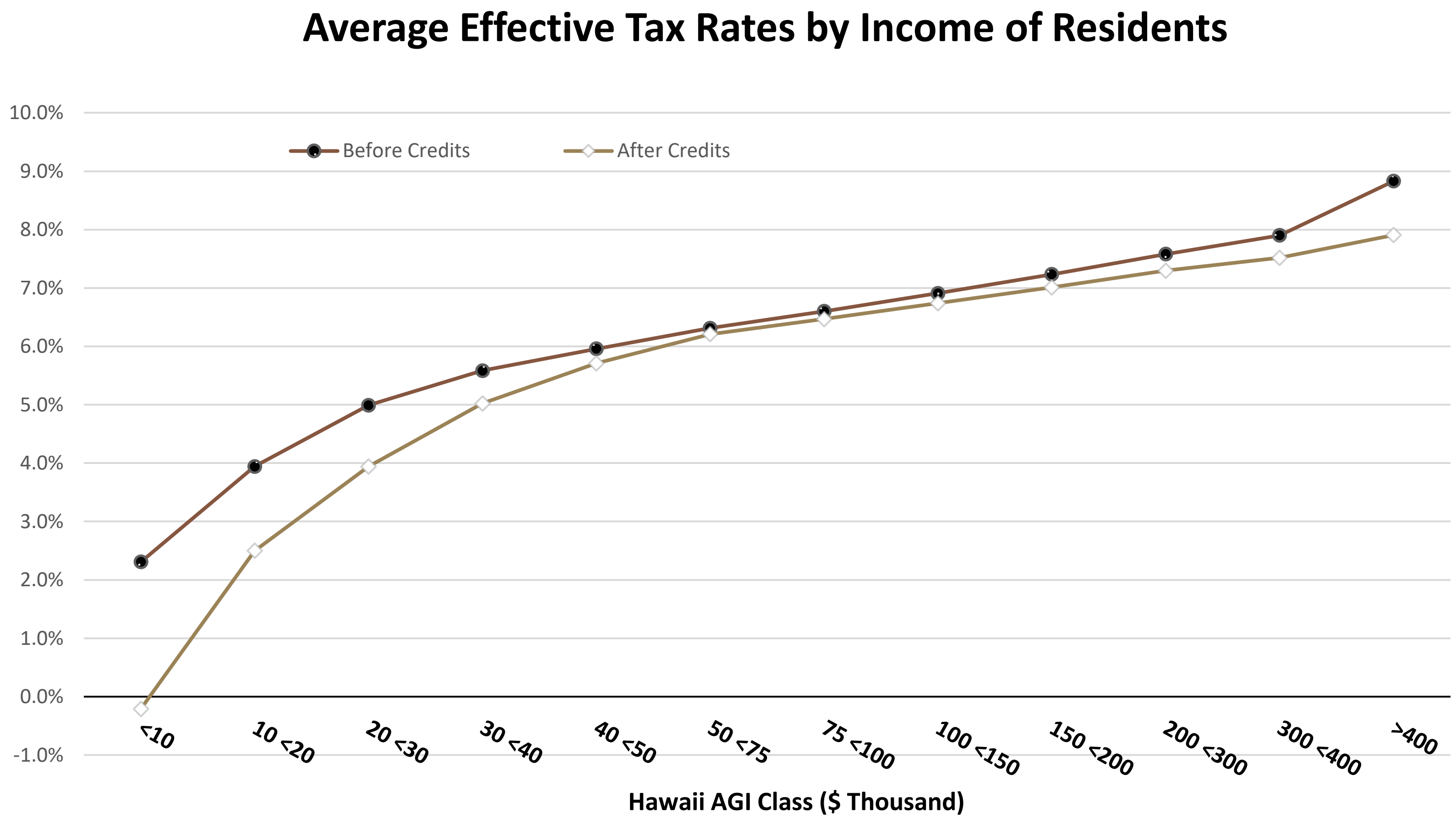
Source: 2018 Income Tax Returns

The highest income earners pay a higher share in taxes than their share of income



Source: 2018 Income Tax Returns

Low-income filers have low tax liabilities and benefit from refundable credits



Source: 2018 Income Tax Returns

Residents pay 92% of all individual income tax

The Exemption of Pension and Social Security are amongst the largest sources of untaxed income

	Taxable Returns		Nontaxable Returns		Total Returns		Est. Rev Loss
	No. of Returns	Amount	No. of Returns	Amount	No. of Returns	Amount	Amount
Total SS and Pension Exemption	**133,668**	**$3,451**	**84,112**	**$2,278**	**217,780**	**$5,729**	**$382**
Exempt Pensions	63,779	$2,212	49,399	$1,794	113,178	$4,006	
Social Security Benefits	69,889	$1,239	34,713	$484	104,602	$1,723	

Dollars (millions)

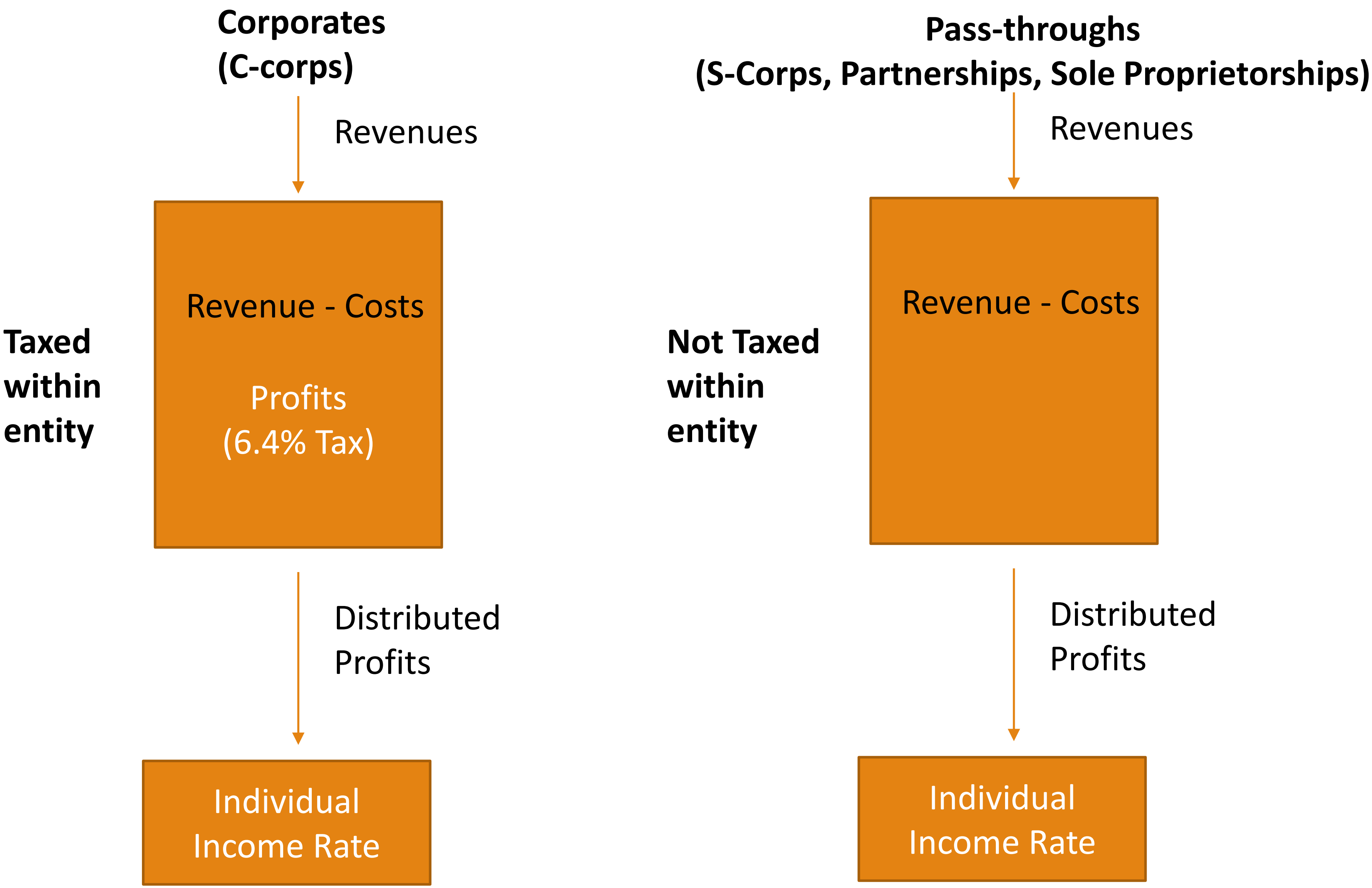
The cost of exempting Social Security and Pensions is $382 million

Assessing the individual income tax

Economic Efficiency	• Provides a disincentive to work • IIT penalizes savings in comparison to consumption tax (mitigated by tax breaks on retirement savings) • High rates (especially in higher incomes) may prompt tax avoidance and lower potential to generate revenue
Fairness	• Progressive, a common mechanism for redistribution
Administrative Burden	• Moderate compliance costs and moderate administrative costs by the government
Stability	• IIT revenue is more volatile than GET revenue

Hawaii's Corporate Income Tax

Corporations are taxed in ways that other businesses are not



A lower corporate tax rate lowers ROI needed to invest

Expected Value = Discounted Future Cash flow * (1- *tax rate*)

In Corporate Finance, investments must meet or surpass a certain ROI (usually risk-adjusted Weighted Average Cost of Capital).

When the tax rate decreases, more projects surpass the investment threshold → More investment (in theory)

A higher corporate tax rate lowers the expected value of investment opportunities

A lower corporate tax rate increases the in expected value of investment opportunities

Features of Hawaii's Corporate Income Tax

Generates a relatively small amount of revenue

- Just 1.5% of total collections (2015-2020)

Of the 44 states that collect corporate income tax, Hawaii ranks 44th in terms of collections per capita

Hawaii's top corporate income tax rate of 6.4% falls in the middle of state corporate taxes nationally.

- Lowest Rate: 3.00% North Carolina
- Highest Rate: 12.00% Iowa

Hawaii's Corporate Tax Rate

Income	**Rate**
<=$25,000	4.40%
$25,000+	5.40%
$100,000+	6.40%

Capital Gains: 4.0%

Corporate Tax Rate

Tax on corporations is passed to consumers, workers, and owners of capital

Economic logic cautions against the use of graduated corporate tax systems since corporate earning is not indicative of "ability to pay"

- Graduated rates incentivize firms to engage into economically wasteful tax planning

Thank You