

TESTIMONY – HB 2991  
A BILL FOR AN ACT RELATING TO PUBLIC FINANCE  
HOUSE OF REPRESENTATIVES  
COMMITTEE ON FINANCE  
FEBRUARY 17, 2010

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*Measure number:*

HB 2991: RELATING TO PUBLIC FINANCE



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The National Education Association strongly supports HB 2991. Passage of this bill would go a long way towards giving Hawaii a tax and revenue structure that is sound, not just for today, in this time of economic recession, but in the long run as well. It would enable the state to make the kinds of investments in education and other services and infrastructure that are crucial and necessary to diversify and modernize the state's economy, and to place its citizens, entrepreneurs, and businesses in an advantageous position to prosper in the new knowledge-based economy of the 21<sup>st</sup> Century.

In particular, this bill wins on two counts: 1) It would result in taxes in Hawaii being fairer than they are currently; and 2) it would result in significant new revenues that would be available for investing in education and other sectors. This would help grow the economy, and would produce a greater return on the investment than would, say, comparable tax cuts.

First, however, we should say that the legislature is to be commended for taking the bold and important step last year of passing HB 1747. This represented a strong, initial step in the process of improving the ability of the state to fund and invest in the services and infrastructure necessary to building and maintaining a prosperous economy for all of its citizens.

### **The balanced-budget constraint**

Hawaii, like nearly every state in the union, is experiencing economic challenges more formidable than any since the 1930s. As property values, personal incomes and corporate profits plummet, so do the sources of revenues that are needed in order to fund all of the services provided by state government. And all the while that revenues are declining, the services they fund are more critical than ever. Constrained as it is by the requirement to balance the budget year in and year out, the legislature is under intense pressure, needing to maintain vital services on the one hand, while on the other hand, contending with the reality that the current tax and revenue structures are not sufficient to support even the current level of services.

In short, in times of recessions, states face the dilemma of whether to fill budget shortfalls by cutting expenditures or raising taxes. A recent Center on Budget & Policy Priorities article put it this way: "States that rely solely or primarily on widespread budget cuts to close deficits are harming residents and businesses that need immediate assistance; they also are reducing demand in the economy and impeding their state's economic recovery."<sup>1</sup> Given the trade-off between raising taxes and cutting expenditures, Nobel Prize-winning economist Joseph Stiglitz, together with now-Congressional Budget Office chair Peter Orszag wrote as the recession began that, "if

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<sup>1</sup> Iris Lav, "A Balanced Approach to Closing State Deficits," February 16, 2010, available at: <http://www.cbpp.org/cms/index.cfm?fa=view&id=3084>

anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run than tax increases focused on higher-income families.”<sup>2</sup>

### **Government expenditures provide investment that is critical to economic growth**

In short, we believe the great preponderance of evidence supports the idea that it is more efficient, and will do more to stimulate future economic growth, to increase (or at the very least, maintain) rather than decrease spending during a recession. We are now far enough into the recession – and recovery – to begin to see clear evidence in support of this. One vital piece of the American Recovery and Reinvestment Act of 2009 (ARRA) was to provide direct assistance to states for the specific purpose of shoring up state budgets for vital services including education. Just last week, Christina Romer, Chairperson of President Obama’s Council of Economic Advisers, was asked what part of the \$787 billion ARRA stimulus package did she like best. In her reply, Romer made it clear that the portion of the ARRA stimulus that went to provide direct fiscal relief to the states has been "one of the triumphs" and that it has even had "more bite than we would have thought."<sup>3</sup>

While we can hope that the federal government will step in and continue (beyond the period covered by the current ARRA stimulus program) to assist Hawaii and the other states in getting through this economic crisis, clearly it is incumbent on you, the members of this Committee, and the legislature as a whole, to take the necessary steps to ensure that Hawaii does not fail in making adequate and necessary investments. We believe that, at this time, smart policy for Hawaii is to raise new revenues, as this bill would do, that will allow the state to not only come through these hard times in as good a shape as possible, but also to begin investing now in a brighter future for the state and its citizens. The question then is, how best to pay for this? We believe the best policy is to ask those who can best afford to do so, to contribute their fair share of the revenues that Hawaii needs to make those sound investments.

### **Hawaii’s tax system is regressive and unable to keep pace with growth in the economy**

At present, even after the changes implemented last year, Hawaii’s tax system is regressive. It places an undue burden on those with the least ability to pay. In fact, if you look at the poorest one-fifth of households in the state, in terms of annual income, you will find that they pay nearly 1 out of every 8 dollars they earn in state and local taxes. That means that the average household in this lower 20% is earning \$9800 and paying nearly \$1200 of that in state and local taxes. That

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<sup>2</sup> Quoted in Nicholas Johnson, “Budget Cuts or Tax Increases at the State Level: Which is Preferable During a Recession?” updated January 12, 2009, available at: [http://www.cbpp.org/cms/?fa=view&id=1032#\\_ftnref3](http://www.cbpp.org/cms/?fa=view&id=1032#_ftnref3)

<sup>3</sup> Jill Lawrence, “Christina Romer on Why We Don't Need a New WPA,” *Politics Daily*, February 12, 2010. Available at: <http://www.politicsdaily.com/2010/02/12/christina-romer-on-putting-workers-on-sale-and-why-we-dont-ne/>

is nearly *double* the share of income paid by those who earn more than \$400,000 per year (6.3%).<sup>4</sup>

One reason the burden is so skewed against the poor is that Hawaii relies heavily on its excise taxes to pay for the costs of government. And while it's a good thing that Hawaii actually leads the nation in sensible sales/excise tax policy – it applies the tax to a broader range of services than any other state – still, the fact remains that excise taxes are by their nature highly regressive, and take a good chunk of money out of the pockets of people who, out of necessity, spend nearly every penny that they earn. In fact, as measured by the Institute on Taxation & Economic Policy – the unchallenged expert on such matters – Hawaii's excise taxes alone eat up fully 10% of the income of households in the bottom fifth of income earners, versus just 1.1% for the top 1% of income earners in the state. In other words, while everyone in the top 1% of Hawaii's income earners pays a penny of every dollar in general excise taxes, those in the bottom 20% are paying a dime out of every dollar on the same taxes. Only one state – Washington – places a heavier excise tax burden on its poorest citizens.

Hawaii's tax revenue structure is not only regressive, it is also "inelastic" relative to growth in its economy. This means that the revenue system isn't able to keep pace with the economy. As a result, revenues are constantly falling behind, which in turn necessitates frequent "fixes" – even in good times. For every 1% of growth in the state's economy, revenues grow at only .93%. This explains why you are constantly having to play catch up just to maintain the current level of services desired by Hawaii's citizens – and why that is true even when the economy is not in crisis. In this current downturn, it is all that more difficult to raise the needed revenues. Of all the available tax sources, the income tax is the only one that is "elastic" to growth in the economy: Income tax revenues grow faster than the rate of economic growth. So, from a practical standpoint, and from the standpoint of building long-term stability into the tax system it only makes sense to look to the income tax – and to the upper income earners – for the additional revenues. This is also the best policy choice from the tax equity standpoint, as well.

### **The rationale for creating new income tax brackets for the highest income earners**

Calling on those most able to pay to contribute an additional share during times of widespread economic distress is a time-honored and rational fiscal policy option. Last year, six of the 10 states with the highest income tax rates – Oregon, California, New York, New Jersey and North Carolina – as well as Hawaii – raised their levies on the highest earners, at least temporarily. In addition, the middle tax rate states of Connecticut and Delaware also raised rates on high-income taxpayers.

A major point to consider is that since the proposed tax on upper-income residents applies only to incomes of \$200,000 or higher (for a couple married filing jointly), a large proportion of any new taxes paid by the state's residents would be deducted from their federal income taxes.

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<sup>4</sup> These data are from the report "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation & Economic Policy, 2009; available at: <http://www.itepnet.org/whopays.htm>

While incomes of \$200,000 are taxed federally at a marginal rate of 28%, that goes up to 33% on earnings in the \$208,850 to \$373,950 range, and to 35% on income earned over and above the amount of \$373,950. Since almost all taxpayers earning over \$200,000 file itemized tax returns, and since state income taxes paid are deductible against federal income taxes, any additional state income tax paid by Hawaii's upper-income residents reduces their federal tax obligation by about one-third of the amount paid to the state of Hawaii. By contrast, none of the excise taxes paid by Hawaii's citizens, rich or poor, is deductible against federal income taxes.

In other words, the income tax increase will be one-third subsidized by the taxpayers in the other 49 states! After filing their federal returns and itemizing deductions, only two-thirds of the additional taxes paid will actually come out of the pockets of Hawaii's citizens. By contrast, any increase in sales or excise taxes would not be so subsidized, since excise taxes paid are not federally deductible. Further, any increase in sales or excise taxes disproportionately adds to the already-unfair burden placed on the state's low-income taxpayers.

It may also be helpful to put the scope of this proposed increase into some perspective: What is being discussed is, at most, a rate increase of from 1.85 - 2.3%, applied only to those portions of a resident's taxable income that fall into the new brackets (from \$200,000 up to more than \$400,000). Recall that after adjusting those rates to account for the federal income tax offset, the true effective rate increase is closer to 1.2 - 1.5%. Are Hawaii's wealthiest residents actually likely to leave the state and move to, say, Alaska, or South Dakota, or Wyoming (or one of the handful of other low income tax states) because of an increase of 1.5% or less in the tax applied only to their earnings over and above \$200,000? (*See addendum for an extended discussion of this question, "If we tax them, won't the wealthy flee?"*)

From an equity standpoint, keep in mind that even with the passage of the tax increases proposed in this measure, Hawaii residents earning over \$200,000 a year would still be paying substantially less of their income in state and local taxes than do Hawaii's citizens earning \$50,000 or less.

### **If not HB2991, then What?**

Finally, the alternative of failing to pass this, or some similar revenue measure, will itself lead directly to a loss of jobs and income in the state in the near-term, and a loss of economic competitiveness and a dimmer future for our children over the longer-term. The National Education Association has estimated that based on historical economic patterns and relationships, \$300 million in funding for public schools would result in 4,900 new jobs in the state. These new positions would be roughly one-third education professionals, one-third other employment in or in support of education (including vendors, contractors, and support service workers), and one-third in the broader economy (in businesses that provide goods and services to customers whose jobs and income traces back to education funding).

Cutting public budgets during an economic downturn compounds the negative job impacts of the downturn, slowing the recovery, and making the pain deeper. Failure to fund vital public services, such as education, because of a downturn is not only bad economics, it passes the cost on to the future and robs our young people of the resources and support that they deserve and

that we need for our own long-term competitiveness. If Hawaii is to succeed in becoming a more diversified economy with wider opportunities and a greater ability to compete in the new global and knowledge-based economy, it must invest in its own future by supporting its educational system and thereby investing in Hawaii's human capital. Committing to make that investment is the best investment you can make for Hawaii's economic growth and vitality.

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#### **AN ADDENDUM FROM THE CENTER ON BUDGET AND POLICY PRIORITIES<sup>5</sup>**

##### **If We Tax Them, Won't the Wealthy Flee?**

Opponents of raising tax rates on high-income households often argue that sensitivity to marginal tax rates is so extreme that those affected will vote with their feet and depart for states where they would pay lower income taxes or none at all. The result, they contend, is to diminish, or even eliminate, the revenue potential of such tax increases.

This argument is highly exaggerated and not based on real-world evidence. Research in New Jersey and California shows conclusively that tax rate increases for high-income residents in fact raise significant amounts of revenue. And recent analysis also shows that tax increases have, at most, only a small impact on interstate migration patterns.

In fact, attempts to measure the relationship between interstate migration and tax progressivity have yielded mixed results. The most recent studies have found that higher marginal income tax rates have a very small impact on where people decide to live. Other factors such as crime rates and the natural environment play a very significant role.

For example, a September 2008 Princeton University study concluded, "the 'half-millionaire tax,' at least in New Jersey, appears to be an effective and efficient revenue-generation mechanism, having little impact on migration patterns among half-millionaire households." The study estimated that New Jersey lost \$37.7 million a year from people leaving the state because of the 2004 tax increase. They called this "a small opportunity cost of a tax policy that generated more than \$1 billion for Tax Year 2006." Furthermore, the study found that household income has grown rapidly among wealthy New Jerseyans in recent years despite the tax. From 2002 to 2006, the number of New Jersey households with incomes of \$500,000 or more grew to 44,000 from 26,000, an increase of 70 percent.<sup>a</sup>

Similarly, an analysis by the California Budget Project found that the number of high-income households in that state has grown substantially during periods in which higher top income tax rates were in effect. According to CBP's findings, "the number of California's joint personal income tax filers with incomes of \$200,000 or more rose by 33.4 percent between 1991 and 1995 — a period in which California temporarily imposed 10 percent and 11 percent tax rates on high income earners." More recently, California enacted a 1 percentage point increase on income over \$1 million. The tax generated new revenue totaling about \$1.5 billion in fiscal year 2008 alone. Much like the pattern observed following the tax increases of the early 1990s, the CBP analysis

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<sup>5</sup> Elizabeth McNichol, Andrew Nicholas and Jon Shure, "Raising State Income Taxes on High-Income Taxpayers," November 11, 2009; available at: <http://www.cbpp.org/cms/index.cfm?fa=view&id=2792>

showed the number of taxpayers with incomes over \$1 million increased — by 37.8 percent from 2004 to 2006.<sup>b</sup>

An analysis by the Institute on Taxation and Economic Policy in May 2009 calls into question the claim that the higher tax rates passed in Maryland in 2007 and 2008 have caused millionaires to leave the state. It suggests, rather, that a drop in the number of tax returns with income greater than \$1 million was due to the recession's impact on people's holdings. Using data from the state Comptroller's office, ITEP found that the second highest tax bracket – for incomes between \$500,000 and \$999,999 – saw a rise in returns, as did the bracket immediately below it. Since tax rates were raised on all three of these tax brackets in 2007 and 2008, ITEP states: “a far more likely explanation for the alleged disappearance of Maryland's millionaires is that, for 2008 at least, they are no longer millionaires. Instead, their incomes may now fall in lower ranges of the distribution, thus potentially accounting for some portion of the increase in the number of returns in those ranges.”<sup>c</sup>

Other research suggests that tax changes alone have little, if any, impact on interstate migration trends. A recent study by the Harvard-trained economist Andrew Leigh, now a professor of economics at the Australian National University, found no significant relationship between income tax changes and migration patterns among U.S. states. According to Leigh, “...tax changes do not impact interstate population flows, nor do they affect the relative wages of movers.” As part of a broader examination of wage inequality and the extent to which tax structures are based on the ability to pay, Leigh analyzed migration patterns of workers along all points of the income scale. Published in the March 2008 edition of the *National Tax Journal*, his work concluded that people are not deterred from moving to states with tax systems under which upper-income residents pay more.<sup>d</sup>

Other studies have found that factors ranging from crime to climate play key roles in explaining state-to-state migration. For instance, Richard J. Cebula found that “non-economic factors play a very significant role in determining migration patterns.” Cebula examined the effect of both economic and non-economic conditions on interstate migration. According to his study, non-economic or “quality-of-life factors” explain much of the recent trends in cross-state migration. Recent migrants were shown to be attracted to states with large amounts of sunshine, warmer winters, and numerous state parks; the study also found that people were less likely to move to states where there are many hazardous waste sites and higher rates of violent crime.<sup>e</sup>

<sup>a</sup> Cristobal Young, Charles Varner, and Douglas S. Massey, “Trends in New Jersey Migration: Housing, Employment, and Taxation,” Princeton University, Woodrow Wilson School of Public and International Affairs, Policy Research Institute for the Region, September, 2008. Available on-line at [www.princeton.edu/prior/](http://www.princeton.edu/prior/).

<sup>b</sup> The California Budget Project, “The Number of High-Income Taxpayers Increased Significantly During a Period With 10 Percent and 11 Percent Tax Rates on High-Income Earners,” August 2008. Available on-line at [www.cbp.org](http://www.cbp.org).

<sup>c</sup> The Institute on Taxation and Economic Policy, “Where Have All of Maryland's Millionaires Gone?,” May 2009.

<sup>d</sup> Andrew Leigh, “Do Redistributive Taxes Reduce Inequality?” *National Tax Journal*, Vol. LXI, 1, March 2008.

<sup>e</sup> Richard J. Cebula, “Internal Migration Determinants: Recent Evidence,” *International Advances in Economic Research*, 11:267–274, 2005.