TAX FOUNDATION
Since 1937

May 2009
No. 169

FISCAL FACT

The Price of Paradise: Hawaii Becomes Fifth State to Adopt New Income Tax Brackets on High-Earners

By Joseph Henchman and Mark Robyn

New Top Rate of 11% on Income Over $200,000 is Highest State Rate in U.S.

The Hawaii Legislature forced through several tax increases on May 11, including an income tax increase and tax increases on cigarettes and other tobacco products, among others. With the exception of the cigarette tax increase, all these tax increases were vetoed by Governor Linda Lingle on May 7 in Hawaii's first-ever public veto ceremony attended by nearly a thousand taxpayers and citizens. However, on May 11 the state legislature was able to override each of the vetoes and enact the tax increases.

The income tax increase is retroactive to January 1, 2009, and expires on December 31, 2015. The cigarette tax will go up on July 1, 2009 and increase again in 2010 and 2011. The hotel accommodations tax also goes up 1 percentage point on July 1, 2009 and again on July 1, 2010, temporarily through 2015. The conveyance tax increase permanently takes effect on July 1, 2009.

State Income Tax Increased, Brackets Added

The broadest tax increase and the one receiving the most attention is an income tax increase on higher-income earners. The legislation adds three income tax brackets on top of the current nine, at rates of 9% on income over $150,000 ($300,000 for joint filers), 10% on income over $175,000 ($350,000 for joint filers), and 11% on income over $200,000 ($400,000 for joint filers). By adding the 11% bracket, Hawaii will move from eighth to first in the ranking of top state income tax rates, passing Maine, New Jersey, Iowa, Oregon, Vermont, Rhode Island, and California. (See Table 1.)

The income tax increase makes Hawaii the most taxing state by some statistical measures. Not only does Hawaii now have the highest statutory income tax rate, 11 percent, but with the increase to twelve tax brackets they now have the most tax brackets of any state. The new bracket structure is rather clumsy in the sense that it is highly graduated for lower-income filers, then flat for middle-income filers, and then highly graduated again for high-income filers. There are nine different brackets between zero and $48,000 ($96,000 for couples) and rates that range from 1.4 to 8.25 percent. But once a taxpayer reaches this 8.25 percent bracket, the next rate takes effect only after taxable income has increased to $150,000 ($300,000 for couples).

The same steeply increasing liability could be achieved with half as many tax brackets or fewer, simplifying a tax structure that can be confusing for taxpayers and accompanied by a real economic burden that increases along with tax complexity.

Hotel, Cigarette, and Real Estate Taxes Also Increased

The hotel accommodations tax rate will rise incrementally from 7.25% to 9.25% by mid-2010. Hawaii relies heavily on tourism, and some tourism-related business owners and their employees are worried that the increase will hurt businesses and cost jobs. Those businesses are fighting against a national trend to foist new taxes on non-residents who have no political power within the state. From a policy perspective, this gouging of non-residents is the wrong approach to taxation. States should focus on enacting simple broad-based taxes without favoring one type of purchase or purchaser over another. Indeed, if every state taxes hotel rooms in a competitive fashion, then a race to higher rates is going on, with each state taxing other states' residents.

The cigarette tax hike is the only component of the tax package that the governor declined to veto. The increase from $2.00 to $3.00 per pack will occur in three increments, increasing to $2.60 on July 1, 2009; $2.80 on July 1, 2010; and $3.00 on July 1, 2011. This tax increase overrides Hawaii's previously scheduled cigarette tax increase which was designed to increase the tax in $0.20 increments until it reached $2.60 in late 2011. With the newly scheduled increase to $2.60 on July 1 of this year, Hawaii will move into third place in the cigarette tax ranking, behind only New York ($2.75 per pack) and Rhode Island ($3.46). In addition, the tax rate on smokeless tobacco has been increased from 40% to 70% of the wholesale price, an increase that the governor vetoed on May 7 but the legislature overrode.

The tax increases on cigarettes and other tobacco products, which are classified as excise taxes, are especially disconcerting. Excise taxes are taxes on specific products or activities, such as gasoline, beer, or cigarettes. Rates should be set at an amount that offsets the so-called negative externalities, or costs to society, associated with the use of such products. Unfortunately, most lawmakers instead view excise taxes simply as easy revenue raisers or a means of achieving their own social policy goals. This is especially true of excise taxes on cigarettes and other tobacco products whose political unpopularity makes them easy targets for tax increases, despite the low income profile of the smoking public.

The conveyance tax on the purchase of residential and commercial property was also part of the flurry of tax increases and a permanent enactment. Previously the highest rate was $0.30 per $100 of value on properties worth at least $1 million. The new legislation adds four brackets to the tax structure: $0.50 per $100 on property worth at least $2 million, $0.70 per $100 on property worth at least $4 million, $0.90 per $100 on property worth at least $6 million, and $1.00 per $100 on property worth at least $10 million.

Hawaii's New Income Tax Brackets Follow Similar Action by California, Maryland, New Jersey, and New York

With its new, dramatically higher income tax rates, Hawaii becomes the fifth state to adopt a so-called "millionaires' tax," joining California, Maryland, New Jersey, and New York. Such taxes are unique in that they impose a top rate near or above 10% on a small subset of high-income earners. The income level at which the new top rate applies is often a sharp jump from where the previous top rate applies, but with each new "millionaire's tax," the tax is kicking in on more and more people who are not millionaires.

Beginning in 2003, New York adopted two new top brackets (the top rate of 7.7% applied to income over $500,000) as a three-year temporary measure, which expired in the midst of the property tax boom at the end of 2005.[1] In 2009, New York attempted to address its budget shortfall in part by adding back the top brackets as a three-year measure, with a top state rate of 8.97% on incomes over $500,000.

New Jersey followed its neighbor in June 2004 when then-Governor James McGreevey signed into law an 8.97% tax rate on income over $1 million, retroactive to January 1, 2004, raising the top rate from 6.37%. While this makes it the first true "millionaires' tax," it was still a lower rate than California's then-top rate of 9.3%, which applied to income over about $41,000. In November 2004, California voters narrowly approved Proposition 63 (53.8% to 46.2%), creating a 10.3% top rate on income over $1 million to fund mental services programs. As part of its 2009 budget agreement, California's top rate has gone to 10.55% for two years, and voters go to the polls on May 19 to decide whether to extend it through 2012.[2]

Also as part of a budget package, one that was designed to pay for expanded state services, Maryland in 2008 added four new income tax brackets, including a top rate of 6.25% on income over $1 million.[3] Notwithstanding their tax increases on high-income earners, New Jersey, Maryland, and California continue to experience serious budget shortfalls that are actually comparatively worse than those in other states.[4]

Table 1
Income Tax Brackets in States with Special Taxes on High-Income Earners
Tax Rates for Singles, 2009

California

Rate	Bracket
1.25%	>$0
2.25%	>$7,168
4.25%	>$16,994
6.25%	>$26,821
8.25%	>$37,233
9.55	>$47,055
10.55%	**>$1,000,000**

Hawaii

Rate	Bracket
1.4%	>$0
3.2%	>$2,400
5.5%	>$4,800
6.4%	>$9,600
6.8%	$14,400
7.2%	>$19,200
7.6%	>$24,000
7.9%	>$36,000
8.25%	>$48,000
9.0%	**>$150,000**
10.0%	**>$175,000**
11.0%	**>$200,000**

Maryland
(Does not include county income taxes, which average 2.98%.)

Rate	Bracket
2.0%	>$0
3.0%	>$1,000
4.0%	>$2,000
4.75%	>$3,000
5.0%	**>$150,000**
5.25%	**>$300,000**
5.5%	**>$500,000**
6.25%	**$1,000,000**

New Jersey

Rate	Bracket
1.4%	>$0
1.75%	>$20,000
3.5%	>$35,000
5.525%	>$40,000
6.37%	>$75,000
8.97%	**>$500,000**

New York
(Does not include New York City income tax, which has a top rate of 3.648%.)

Rate	Bracket
4.0%	>$0
4.5%	>$8,000
5.25%	>$11,000
5.9%	>$13,000
6.85%	>$20,000
7.85%	**>$200,000**
8.97%	**>$500,000**

Taxing High-Income Earners Has Failed Before as Sound Fiscal Policy
The trend may be new, but the policy has been tried before. Through the early 1990s, several states maintained double-digit income tax rates, including California (11% until 1996) and Hawaii (10% until 1998).[5] These rates came down due to a combination of booming tax revenues from all sources, and growing expert understanding that location decisions of highly mobile entrepreneurs are sensitive to state income tax rates, particularly in the interstate context. To attract and keep good talent, create jobs and drive economic growth, legislators knew that state tax systems had to be competitive with their neighbors.

We still see elements of that today. Even in adopting its millionaires' tax, New York did not let its rate go above neighboring New Jersey, and other states are wary of crossing the 10% psychological barrier. The California Franchise Tax Board has taken pains to deny that their 10.3% top tax rate is in the double digits, referring on their website and on tax forms to a 9.3% top rate and elsewhere noting that there is a 1% surcharge.[6] Now those rates are 9.55% and 10.55% (see Table 1).

If states are still concerned about interstate tax competition, what has really changed? The short answer is priorities. States that adopt new taxes on high-income earners are ones where policymakers are persuaded to ignore concerns about long-term economic growth in favor of a short-term budget fix that avoids deep spending cuts. In New Jersey, while the new millionaires' tax raised revenue for the state and helped reduce a budget shortfall, it reduced the state's overall economic output and harmed its ability to grow during and after the recession.[7]

This is the tradeoff that proponents of taxes on high-income earners usually fail to acknowledge. Yes, such taxes will generally raise revenue in the short term without a sudden exodus of wealthy people fleeing to the state next door, especially in Hawaii. But over the medium term, the taxes will negatively impact location decisions. People expanding old businesses or creating new ones will incorporate the higher cost of doing business into their decision-making, and steer clear of the state. California currently faces an enormous brain drain of dynamic individuals after five years of double-digit income taxes, and it seems that New Jersey may now be seeing the evidence of a brain drain from its millionaires' tax. Hawaii has long been accused of chasing out its best and brightest, and it can only be exacerbating that problem with these new tax rates.[8]

In Hawaii, the tourism industry bears a disproportionate tax burden in an already high-tax state, and the tax package seemingly left no stone unturned in exacerbating that. Officials were apparently convinced that Hawaii's location minimizes the economic impact of further tax increases. With hotel occupancy at a low and likely to go lower with the hotel tax increase, and with special funds raided and the state's commitment to provide tax incentives for high technology development ($130 million a year as of 2007), the revenue Hawaii hopes to see from the tax increase may be illusory.

New taxes on high-income earners have the best chance of success where policymakers are persuaded to focus just on short-term problems and minimize concerns about long-term economic growth. It is true that paying for unemployment benefits and state services is a bigger challenge in a time of recession. Officials from President Obama and Vice President Biden on down have talked about how high-income earners should pay "a bit more," with references to patriotism, duty or fairness.

But, as we noted in our state budgets report in February, such rhetoric does not address some major concerns. First, state budget shortfalls are a result of trying to keep spending commitments based on naïve assumptions about tax revenue growth from the boom; ultimately states will need to reprioritize those promises. Second, paying for broadly available public services through disproportionate taxes on high-income earners raises serious equity questions. Third, such taxes are highly volatile and contribute to the boom-and-bust cycle of state budgets because the incomes of such individuals are so volatile, more so than other types of tax revenue. Finally, such taxes can undermine long-term economic growth.

Policymakers and stakeholders in states considering taxes on high-income earners should raise these concerns and resist efforts to substitute damaging short-term fixes for real long-term pro-growth tax reform.

Notes

1. For New York City residents, the 7.7% state rate combined with the 3.648% city rate resulted in a double-digit income tax rate.

2. The budget agreement raised every tax rate by 0.25 percentage points. The bill contained language to cut the increase to 0.125 percentage points if California received at least $10 billion in federal stimulus funds. On March 27, 2009, Treasurer Bill Lockyer certified that the state would receive only $8.6 billion in stimulus funds, resulting in the 0.25 percent rate increase.

3. Maryland has uniquely high county income taxes which average approximately 3 percent of income, so the 6.25% state-level rate brings the tax rate over 9 percent of almost all high-income Marylanders.

4. *See generally* Joseph Henchman, "State Budget Shortfalls Present A Tax Reform Opportunity," *Tax Foundation Special Report* No. 164 (Feb. 2009), at http://www.taxfoundation.org/publications/show/24321.html.

5. Some states had double-digit income tax rates since the 1990s, but also permit deduction of federal taxes from the state income tax. In these states (such as Montana in the 1990s and Iowa today), the high marginal tax rate on personal income is not immediately comparable to other states because of deductibility.

6. *See* William Ahern, "California Legislators Push for More Double-Digit Income Tax Rates," *Tax Foundation Fiscal Fact* No. 134 (Jul. 14, 2008), at http://www.taxfoundation.org/research/show/23370.html.

7. *See* Gerald Prante, "Did People Flee New Jersey After 2004 Income Tax Hike?," Tax Foundation Tax Policy Blog (Apr. 14, 2009), at http://www.taxfoundation.org/blog/show/24618.html.

8. See, e.g., "Brain Drain has Many Casualties" *Honolulu Star Bulletin*, April 16, 1999, *available at* http://archives.starbulletin.com/specials/braindrain.html; University of Hawaii at Mānoa, *Alumni Outcomes Survey 2003 available at* http://www.hawaii.edu/offices/app/opp/alumni/alumni03.pdf (finding that more graduates are moving out of state); University of Hawaii at Mānoa, *Discussion Brief*, 2008-4 v.4 *available at* http://vcafo.org/support_bulletin/2008-4.pdf (finding that large percentages of public school graduates leave the state).

Tax Foundation
529 14th Street NW, Suite 420
Washington, DC 20045
Ph: (202) 464-6200
www.taxfoundation.org