MEMORANDUM

Date: October 19, 2021

To: Tax Review Commissioners

From: Commissioner Kate Lloyd

RE: Proposed 2022 Tax Review Commission Recommendations on Personal Exemption and Standard Deductions

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I am submitting the following proposed recommendation for the commission's discussion and decision-making at our meeting on October 13, 2021.

The Hawaii Tax Review Commission urges the legislature to modernize Hawaii's individual income tax by increasing the standard deduction and personal exemption amounts and provide for an automatic index for inflation thereafter for both the personal exemption and standard deduction. At a minimum, <u>the Tax Review Commission recommends that the legislature consider both doubling the current standard deduction and immediately indexing the standard deduction and personal exemption amount to Hawaii's inflation rate. Furthermore, Hawaii Tax Review Commission urges the legislature to adjust Hawaii's income tax brackets for inflation to avoid unduly burdening lower income taxpayers.</u>

The standard deduction and personal exemption in Hawaii's individual income tax system have been eroded over time by inflation and are now outdated. Recommendations to increase the standard deduction have been made by all past Tax Review Commissions and this has been identified as a way to eliminate the income tax for those below the poverty level and increase progressivity of the overall tax system. The 2017 PFM study identified increasing the standard deduction as one of the optimal alternatives for reducing regressivity in Hawaii's tax system.

Experimental analysis performed by our consultant estimated the revenue impact on doubling, tripling and quintupling the standard deduction. Doubling the standard deduction, based on 2019 tax year data, showed a relatively modest revenue impact of -2.04% or a loss of $50 million. <u>See</u> Revenue Estimates Statistical Analysis and Background Research; Hawaii standard deduction and personal exemptions, September 22, 2021 Baybars Karacaovali, Ph.D. That same analysis showed a 4.5

million dollar loss over a five-year period based on indexing the standard deduction alone. Either of these scenarios would be an improvement in the progressivity of our tax system and increase the fairness of our tax system for those with the lowest incomes.

Similarly, the revenue impact to indexing the tax brackets to Hawaii inflation shows a base revenue impact of $8.9 million, with the reduction in tax liability highest for lower income taxpayers.

<u>Questions to be addressed by DoTax or the Consultant and incorporated into the recommendation</u>:

- Calculate the revenue cost of indexing the personal exemption for inflation.

- Determine whether increasing the standard deduction and/ or personal exemptions eliminate the need for many or most low-income taxpayers to file Hawaii state tax returns?   The filing thresholds for individuals receiving gross income subject to Hawaii income tax law, is calculated by adding the standard deduction and personal exemption.

- Address whether withholding rates would need to be adjusted accordingly so more taxpayers would not need to file the return to get a refund for withholding.

- Address how many taxpayers would benefit from the increase and what demographic would be most benefited. With the Earned Income Tax Credit, much of the liability for these taxpayers might be eliminated anyway, if so an argument can be made that the changes are revenue neutral but at the same time would increase simplicity of the tax system if avoiding the need to file- while the earned income tax credit may reduce overall tax liability – the changes discussed above may be more beneficial to lower income earners who could anticipate a change in positive cash flow.