SB1346

Date: 02/11/2009

Committee: Senate Education and Housing

Department: Education

Person Testifying: Patricia Hamamoto, Superintendent of Education

Title of Bill: SB 1346 RELATING TO TAXATION.

Purpose of Bill: Increases the general excise tax to fund public education; exempts groceries, certain medical expenses, and a portion of rent from the general excise tax; establishes a state earned income tax credit; establishes a tax credit for volunteer services performed in public schools; increases the standard deduction; establishes an education funding commission to provide oversight for general excise tax revenues deposited into the newly created education special fund.

Department's Position: The Department of Education supports this measure, with some areas of concern and some recommendations for amendments.

First of all, the Department of Education appreciates the Legislature's attempts to provide a consistent, long-term, sustainable source of funding for public education. Regarding the proposed tax increases, those are public policy decisions. We defer to the State Department of Taxation for comments on implementation of the bill's provisions.

There are two areas of concern from the Department of Education's perspective:

1. Volunteer Tax Credit: Although we applaud the Legislature's support for volunteers for public schools, in this measure, the State Department of Taxation is directed to provide a method of documenting the actual performance by taxpayers of the hours of general volunteer services. The Department of Education has been attempting to address the challenges of gathering of data on volunteers. A pilot comprehensive system of tracking volunteer data has been implemented at certain schools; however, the statewide implementation of this volunteer tracking system is

far from completion. We are currently using a web-based software at helphawaiischools.com that captures volunteer profile information completed online and is updated by volunteers themselves. The system also uses an electronic version of a time clock where volunteers sign in and sign out at a computer workstation, minimizing the need for data entry by schools except to verify hours and generate reports. The tool can also be customized to add new or different fields as needed. The number of volunteer service hours performed can also be captured for any date parameters queried. This tool is currently the only system being used to document general volunteer services (and donations) in a comprehensive and efficient way for schools. However, we currently only have 42 schools participating in this first year of implementing the pilot program, out of 257 schools, representing 16% of our schools. Additional funding of approximately $315,000 would be needed to expand the use of the tool by all schools if an accelerated timeline were required, for the remaining 84% of our public schools to implement this volunteer tracking system.

2. Education funding commission: The Department of Education opposes creating an education funding commission, which is defined by the measure as being "within the Department of Education, for administrative purposes only," and consists of eleven members, of which the appointing authority of Senate and House members is unclear. The measure states that this commission would determine allocations of the special fund monies, for capital improvement program (CIP) and repairs & maintenance (R&M) projects, weighted student formula needs, etc. We are very concerned that creation of a commission would establish a miniature of the existing Legislative and Executive Branches, within the Department of Education, to decide how to use these special funds. We can foresee funding allocations possibly biased towards the constituent geographic areas of the Legislative Branch members, and influenced by the Executive Branch's policies, which may differ from that of the Legislative Branch members.

Therefore, the Department of Education recommends the following amendments to this measure:

a. Consult with the State Department of Taxation for alternatives to structure the volunteer tax credit, with perhaps recommendations to simplify the proof of volunteer work at public schools.

b. Remove the education funding commission section of this measure, and replace it by assigning the responsibility of allocations of the education special fund to the Board of Education, assisted by the Department of Education.

c. If the Legislature prefers to have some influence on the allocations of this education special fund among the initiatives listed in the bill in Section 4, we recommend that the Legislature establish set percentages, such as 50 percent on operating budget items: weighted student formula, learning materials, technology and equipment, workforce training, financial and management audits; and 50 percent on capital (CIP/R&M) projects. The Board of Education can be designated as the authority to oversee the Department of Education's implementation and compliance with these percentages.

The Department supports SB 1346 with the above-mentioned recommendations as long as its implementation does not impact or replace the priorities set forth in the Executive Biennium Budget for 2009-2011. Thank you for the opportunity to provide testimony.

LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

SENATE COMMITTEE ON EDUCATION & HOUSING
TESTIMONY REGARDING SB 1346
RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 11, 2009
TIME: 2:30PM
ROOM: 225

This measure seeks to increase the general excise tax (GET), as well as provide various GET exemptions, increase the standard deduction, and provide an earned income tax credit (EITC), among other things.

The Department of Taxation (Department) **supports the intent and purpose of the tax relief provisions of this legislation**, but respectfully **opposes the tax increase and other components** due to its fiscal implications and the extreme burden that it would place on the taxpayers of the State. The Department does support certain limited portions of the measure standing alone.

I. GET INCREASE

A. General Comments

This measure seeks to increase the GET by an unspecified amount. The GET is the broadest of state taxes applying to all gross income or gross proceeds of a business, unless exempt. The GET collections also constitute over 50% of the general fund revenues. The GET is an effective tax because of its broad base and low rate. It is capable of having such a low rate purely as a result of the breadth of its tax. To modify the tax base or to increase its rate could dramatically impact the tax policy and collection that the State has relied upon for decades.

The Department opposes the GET increase at this time. At a time when the State's economy is struggling greatly, the Department cannot support a 25% tax increase on the daily costs incurred by Hawaii families, assuming a 1 percent increase. Though the increase in GET is laudably offset by various exemptions and credits, the Department is unsure that such offsets will markedly reduce such a regressive tax increase.

In short, the Department cannot support a tax increase such as this when the economy cannot handle such an increase and Hawaii will become a less attractive and more regressive state to live and conduct business.

B. Revenue Estimate

The GET tax increase proposed in this measure will result in an indeterminate revenue gain due to its blank amount.

II. GET INCREASE FOR DEPOSIT TO THE BENEFIT OF SCHOOLS

Though the Department appreciates the intent of providing additional funding for schools, the Department believes that the current Department of Education budget is sufficient.

Moreover, during a time when the budget and the general fund are at their most delicate point this session, the Department cannot support a tax increase to fund a special fund. Any discussion of increasing tax revenues this session must be deposited to the benefit of the general fund in order to balance the budget this session.

III. CREDIT FOR VOLUNTARY SERVICES

A. General Comments

The measure provides an unspecified credit for volunteer services performed for public schools by a resident. In addition, it excludes from the credit volunteer services that are performed by a person who is also a paid employee of the school.

The Department is concerned with the definition of "volunteer services," which could leave the determination up to the individual taxpayer and be subject to varying interpretations. The Department would also have to expend substantial resources to insure that only qualified individuals obtain the credit and would need to inquire of the schools whether the individual did in fact volunteer some services and that the services provided were material. In order to alleviate some of the burden on the Department, the Department suggests that the taxpayer should be required to obtain a certification from schools stating the taxpayer did provide volunteer services of the type that is being encouraged by this legislation.

This measure could also open the door to fraud and collusion by a school employee and other individuals whereby the employee could verify that services were performed when in fact none were in order for the individuals to obtain the credit.

The Department also notes that the amount of the credit received by an individual would be subject to state and federal income tax.

B. Revenue Impact

This credit will result in an indeterminate revenue loss because the credit amount is blank.

IV. EARNED INCOME TAX CREDIT

A. General Comments

The Department opposes the EITC and recommends more simpler solutions for the poor, such as increasing the standard deduction.

The Internal Revenue Service (IRS) admits that the EITC has been plagued by persistent compliance problems. The IRS has been unable to reduce noncompliance problems significantly. Between $8.4 and $9.9 billion (27% to 32%) in EITC claims have been paid improperly as reported in a compliance study of tax year 1999 returns. The EITC credit is listed as a "*high risk area for the federal government*" by the General Accounting Office. *See EITC Reform Initiative*, FS-2003-14, June 2003). In its 2005 EITC Initiative Final Report to Congress, the IRS stated that although "the IRS has implemented a number of legal and administrative changes since [the 1999 study], IRS officials believe the error rate is still substantial." The 2005 report, in an analysis of preliminary data from tax year 2001 returns stated that EITC over claim estimates would not be "substantially different" than that of tax year 1999. *See http://www.irs.gov/pub/irs-utl/irs_earned_income_tax _credit_initiative_final_report_to_congress_october_2005.pdf.*

"The EITC credit is a social welfare program embedded in the tax code where the tax system primarily relies on self-reporting." (*See EITC Reform Initiative*, FS-2003-14, June 2003). Unlike other social welfare programs, no requirement is imposed for EITC eligibility proof prior to payments and the payments rely on the claimants' self-assessment for eligibility. Crucial EITC eligibility factors such as marital status, residency, and the relationship test of a claimed child, are difficult for the IRS to confirm. *See id*.

IMPACTS TOO FEW—The EITC tax benefits do not outweigh the administrative burden. The Federal EITC is only available to taxpayers who meet the eligibility criteria. To name a few, the taxpayers must have earned income and cannot exceed the earned income ceiling; must be between 25 to 65 years old; and must not file "married filing separate returns".[1] The tax benefits provided by the EITC program do not cover the wide range of taxpayers, which is accomplished by increasing the standard deduction. For example, the EITC phases out at the following levels for 2008—

Number of Children	**Filing Single**	**Filing Joint**
0	**$12,880**	**$15,880**
1	**$33,995**	**$36,995**
2 or more	**$38,646**	**$41,646**

1 The Department suggests that the provision in the bill allowing a husband and wife to file separately and claim the credit be eliminated.

ADMINISTRATIVE BURDEN—The bill would place an administrative burden on the Department due to the high rate of noncompliance with respect to the Federal EITC claims. The requirement of the Department alerting eligible taxpayers of the proposed Hawaii EITC would also place an adverse administrative burden on the Department. Due to the unclear and incomplete annual reporting requirements set forth in this bill and the existing annual reporting of tax credits claimed by Hawaii taxpayers, the Department would be unduly burdened in compiling duplicate reports.

TANF MONEY IS THE ONLY MONEY THAT SHOULD BE RISKED—The Department appreciates that this measure utilizes federal TANF money to accomplish its purpose. However, the use of TANF funds is limited to the 2009 taxable year. The Department suggests modifying this provision so that only TANF funds are put at-risk of the noncompliance in this area. General fund revenues should not be subjected to the high level of abuse experienced with the EITC.

RESOURCES—This bill requires the Department to alert taxpayers to the ability to claim this credit. Public outreach costs could be substantial in order to provide adequate notice of this tax credit. Moreover, given the high fraud costs associated with this bill, the Department will likely focus audit efforts toward fraudulently claimed EITC credits. As a result, the Department respectfully requests a reasonable resource allocation for the costs of implementing the public outreach and fraud mitigation efforts.

B. Revenue Impact

A 20% conformity to the federal EITC will cost approximately $25.8 million annually in TANF money.

V. EXEMPTION FOR FOOD, OVER-THE-COUNTER DRUGS, AND MEDICAL SERVICES FROM GET

A. General Comments

The Department **supports tax relief in a form similar to the general excise tax exemption** on certain foods and nonprescription drugs, as well as medical services.

The Department supports measures that assist struggling families and individuals by decreasing their state tax burdens. This bill specifically targets the overly regressive nature of the GET, which applies at the same rate to all taxpayers, regardless of their income level, to all staples of life. This exemption mitigates the regressive effects of the GET imposed on food and over-the-counter medications that is passed on to consumers. By eliminating the GET on these items, lower income families will have more to spend on the necessities of life.

The measure fails to adequately define "food item" or "over-the-counter medicine." "Food item" is defined as "any food or food product for home consumption except alcoholic beverages, tobacco, and food products prepared at the place of sale or at another location and sold primarily for immediate or nearly immediate consumption. In the case of those persons who are sixty-five years of age or older or who receive supplemental security income benefits under Title XVI of the Social Security Act (42 U.S.C. §1381 et. seq.), and their spouses, "food items" includes meals prepared by and served in senior citizens' centers, apartment buildings occupied primarily by senior citizens, private nonprofit establishments (eating or otherwise) that feed senior citizens, private establishments that contract with the appropriate agency of the State to offer meals for senior citizens at concessional prices, and meals prepared for and served to residents of federally subsidized housing for the elderly." This definition leaves unanswered whether such things as candy or soft drinks (which in many jurisdictions is not deemed to be food exempt from sales tax) is or is not exempt from the GET. To truly comprehend whether certain food products are exempt, the analysis is typically over whether the items are fresh produce, milk or other fresh beverages, or contain flour in their ingredients.

Likewise, "over-the-counter nonprescription medicine" is defined as "drugs or medications that can be purchased without a prescription (for example, aspirin, cough syrup, and laxatives)". This leaves to speculation about whether various items are or are not subject to the exemption. For example, is common rubbing alcohol and other ointments, vitamins, and food supplements included as an over-the-counter nonprescription medicine? The Department foresees substantial unease by the retailing community because of the lack of guidance on what constitutes a food stuff or an over-the-counter nonprescription medicine, and the Department would be required to expend substantial resources to draft rules over the meaning of these phrases.

The Department supports the GET exemption for physician and dentistry services because no one should be taxed for being sick.

B. Revenue Impact

The exemptions discussed above result in the following revenue impacts—

- Exemption for food--$135 million per year
- Exemption for medical services and nonprescription drugs--$126 million per year

VI. <u>GET EXEMPTION ON RENT</u>

A. General Comments

The Department recognizes the importance of providing assistance for low-income rental housing.

The Department has concerns over the GET exemption on rent. The GET is a tax on the business, or in this case the landlord. The Department is unsure that the economic benefit of exempting rent from the GET will necessarily calculate into lower rents. There is no requirement that a landlord has to charge lower rent simply because it will no longer be taxed.

B. Revenue Impact

The exemption for rental income is indeterminate because the amount is blank.

VII. INCREASING THE STANDARD DEDUCTION

A. General Comments

The Department **strongly supports** tax relief in the form of increasing the standard deduction.

Hawaii's personal income tax system consists of nine brackets with top rate of 8.25% kicking in at an income level of $40,000 for individuals. Increasing the Hawaii standard deduction will provide timely and meaningful tax relief in the following substantial ways:

1). **FEWER LOW-INCOME TAXPAYERS WILL OWE TAX—**Currently, the very low-income citizens of Hawaii are paying state income tax, but not federal income tax. This disparity is exclusively due to the fact that Hawaii's standard deduction is markedly lower than the federal, thus requiring the poor to file. By raising the standard deduction, a large percentage of the very low-income will have immediate tax relief because they won't owe any Hawaii taxes.

2). **LESS ITEMIZED DEDUCTIONS—**By increasing the standard deduction, more filers will be able to take the standard deduction, rather than itemize. The larger standard deduction will increase collections, lower fraud, and relieve the burden faced by the Department in processing itemized schedules.

3). **REFLECTS THE REALITY OF HAWAII'S COST OF LIVING—**Under this proposal, Hawaii's tax system becomes more progressive and equitable by providing tax relief directly to the low-income taxpayers whom, as a group, almost always rely on the standard deduction to deal with the high cost of living. This proposal will keep more money in the pockets of Hawaii citizens who need tax relief the most, rather than waiting for a tax refund.

Increasing Hawaii's standard deduction is also better tax policy when compared to the alternative of providing an earned income tax credit because:

1) Raising the standard deduction wholly eliminates low-income taxpayers from any income tax assessments;
2) There is a substantial amount of fraud that accompanies the earned income tax credit that the State could avoid;
3) Raising the standard deduction helps far more taxpayers;
4) Tax professionals almost unanimously support the notion of increasing the standard deduction; and
5) The standard deduction is far easier than the earned income credit for taxpayers to

understand.

B. Revenue Impact

Increasing the standard deduction will result in a revenue loss of $37.5 million per year.

HAWAII STATE TEACHERS ASSOCIATION
Teaching Today for Hawaii's Tomorrow

1200 Ala Kapuna Street ◆ Honolulu, Hawaii 96819
Tel: (808) 833-2711 ◆ Fax: (808) 839-7106 ◆ Web: www.hsta.org

Roger K. Takabayashi
President

Wil Okabe
Vice President

Karolyn Mossman
Secretary-Treasurer

Mike McCartney
Executive Director

TESTIMONY BEFORE THE SENATE COMMITTEE ON
EDUCATION AND HOUSING

RE: SB 1346 – RELATING TO TAXATION

February 11, 2009

ROGER TAKABAYASHI, PRESIDENT
HAWAII STATE TEACHERS ASSOCIATION

Chair Sakamoto and Members of the Committee:

The Hawaii State Teachers Association agrees with the intent of SB 1346, which will increase the general excise tax (GET) to fund public education and establish an education funding commission to provide oversight for general excise tax revenues deposited into the newly created education special fund, along with exempting certain expenses from the GET and establishing certain tax credits. HSTA appreciates the Legislature's support for the betterment of our public school education system in Hawaii. The bill will also benefit local taxpayers in the form of tax relief or credits for certain line items.

In the current economic situation, we are facing major budget cuts that will gravely affect the education services we provide to the children of Hawaii. Raising the GET will help generate the necessary funds needed to offset current and future budget cuts by the Department of Education (DOE). We understand that the revenues generated from the increase will be placed in an Education Special Fund, to be used for repair and maintenance (R & M) projects, capital improvement projects, learning materials, technology and equipment, increasing the base per pupil allocation in the weighted student formula, and providing workforce training for teachers.

HSTA agrees that it is necessary to find solutions to compensate the budget cuts, and this bill to raise the GET is a conscientious solution. However, we would like to suggest that the Legislature also look toward the collection of unpaid taxes which potentially could amount to approximately $7 million.

Thank you for the opportunity to testify.

February 11, 2009
2:30 p.m.
Conference Room 225

TESTIMONY TO
THE SENATE COMMITTEE ON EDUCATION AND HOUSING

RE: SB 1346 – Relating to Taxation

Chair Sakamoto, Vice Chair Kidani, and Members of the Committee:

My name is Robert Witt and I am executive director of the Hawaii Association of Independent Schools (HAIS), which represents 97 private and independent schools in Hawaii and educates over 30,000 elementary and secondary students statewide.

The Association strongly supports the intent of Senate Bill 1346 – Relating to Taxation, which proposes an increase in the general excise tax to generate additional funding for early education and public schools in Hawaii.

While HAIS primarily advocates on behalf of Hawaii's independent schools, our board of directors places high priority on the active participation of the Association in the educational community for the benefit of all children, in all schools. To that end, we are regular contributors to the State's educational policy dialogue, collaborating with the Department of Education and other education-related organizations in both the public and private sectors to support early childhood education, public elementary and secondary education, charter school education, and higher education.

We steadfastly believe that when investments are made in schools the returns are enormous, and that an increase in our state's overall investment in education – through means like those proposed by this measure, such as dedicated funding transmitted directly to public schools and complex areas from the State and tax credits for those who volunteer their services at public schools – will produce significant dividends for all of us in Hawaii, for many years to come.

Thank you for this opportunity to testify.