

Long-Term Services & Supports Feasibility Policy Note

Exploring Financing Options for a Public Long-Term Care Program

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In 2014, a report was published examining the feasibility of a long-term services and supports (LTSS) social insurance program for the State of Hawai'i. The report offered four models to finance such a program – a flat premium for working Hawai'i residents, a flat premium for the whole population, an income-tax surcharge for the whole population, and a general excise tax (GET) surcharge – and due to a variety of reasons, it was decided that a general excise tax surcharge was the optimal mechanism for funding the program.

Recent concerns over a general excise tax surcharge has re-focused the spotlight on the financing mechanism of a LTSS social insurance program, particularly with the feasibility and the economic and policy implications of some sort of income or payroll tax. The purpose of this policy note is to examine potential issues of an income or payroll tax, and to briefly address the concerns with a general excise tax surcharge. First, this note will make note of the recent discussions regarding the general excise tax. Then, it will consider the income and payroll tax. Lastly, it will present some possibilities to reduce the questions surrounding the general excise tax surcharge.

1. What's wrong with a GET surcharge?

The major issue that seems to arise when critiquing the GET surcharge is the regressive nature of such a tax. When nearly all goods and services have a tax placed on the consumption of these goods and services, poorer households will end up paying a higher percentage of their income on these taxes. Wealthier households are not spending as much of their income, proportionally speaking, as poorer households (higher income households have higher rates of saving), thus wealthier households pay a lower percentage of their income on sales and general excise taxes.

In contrast, income and payroll taxes tend to be thought of as progressive or flat taxes. Income taxes can be adjusted according to income, allowing for individuals and households with higher incomes to pay a higher percentage of their income on income taxes (for example, in Hawai'i, earning \$2,000 results in an average income tax of 1.4%, while earning \$66,000 results in an average income tax of 7.1%). Alternatively, payroll taxes are usually flat; payroll taxes remain unchanged, regardless of income earned. There is one small caveat for payroll taxes, though. Some payroll taxes, such as the Social Security taxes, have a limit on how much income be taxed. Currently, the limit on taxable income sits just under \$120,000. Anyone earning more than the \$120,000 will only have to pay Social Security taxes on the first \$120,000, and any additional income is untaxed. This mechanism makes payroll taxes regressive, but certainly not to the degree of regressivity of sales taxes.

2. What happens with an income tax?

As mentioned previously, income taxes can be designed very carefully to be progressive, addressing the concern over regressivity. Further, because of the flexibility of an income tax, funding the program would have minimal issues, should there be a willingness to tax richer households at a high marginal rate. However, the income tax does not come without its own issues.

The primary problem with an income tax stems from the recent backlash to the notion of taxing retirement benefits. Since the taxing of retirement benefits has been known to upset people, the program can certainly be designed to not tax retirees. However, this again does not come without issues. Without current retirees paying into the program, there is likely to be minimal support to provide benefits to these retirees; why distribute benefits to individuals who have made no contribution to the program? Note that this argument is very different from claiming that current retirees should not receive any benefits whatsoever. Instead, the argument is “with an income tax in place, how do we ensure retirees are at least making nominal payments into the system?” Further, without a tax on current retirees, the actuarial model treats an income tax similar to a payroll tax, and as the following section will show, this method of financing the program is not sustainable to the degree that the GET surcharge is.

3. What happens with a payroll tax?

The benefit of a payroll tax is that instead of getting involved in a fiasco with regards to retirement benefits, a payroll tax avoids the issue altogether, since retirees are not on payrolls. This, of course, results in the major issue similar to the problem brought up in the previous section on income taxes. Retirees are not on payroll, thus they do not make contributions to the system; does it make sense to give them benefits? With a payroll tax in place, how do we ensure retirees are at least making nominal payments into the system?

Unfortunately for payroll tax proponents, even if this was to be resolved satisfactorily for all sides, the payroll tax has one fatal problem: a payroll tax is all but unsustainable for a public

LTSS program¹. With a tax on only current workers, as with an income tax that excludes retirees or a payroll tax, the tax has to be set around 1% in order to be sustainable for the first few decades. Given poor economic conditions, such as the pessimistic ones proposed in Policy Note 9, in order for such a tax to be sustainable for a few decades more, either the tax needs to be raised significantly after funds are close to depletion, or the tax needs to be initially set close to 2%. For illustrative purposes, compare the two financing models under the various economic assumptions in Figure 1 and Figure 2. A payroll tax consistently distributes less benefits while taking in significantly less income, despite significantly higher tax rates, compared to a GET surcharge.

Figure 1: “Solvent” Economic Assumptions

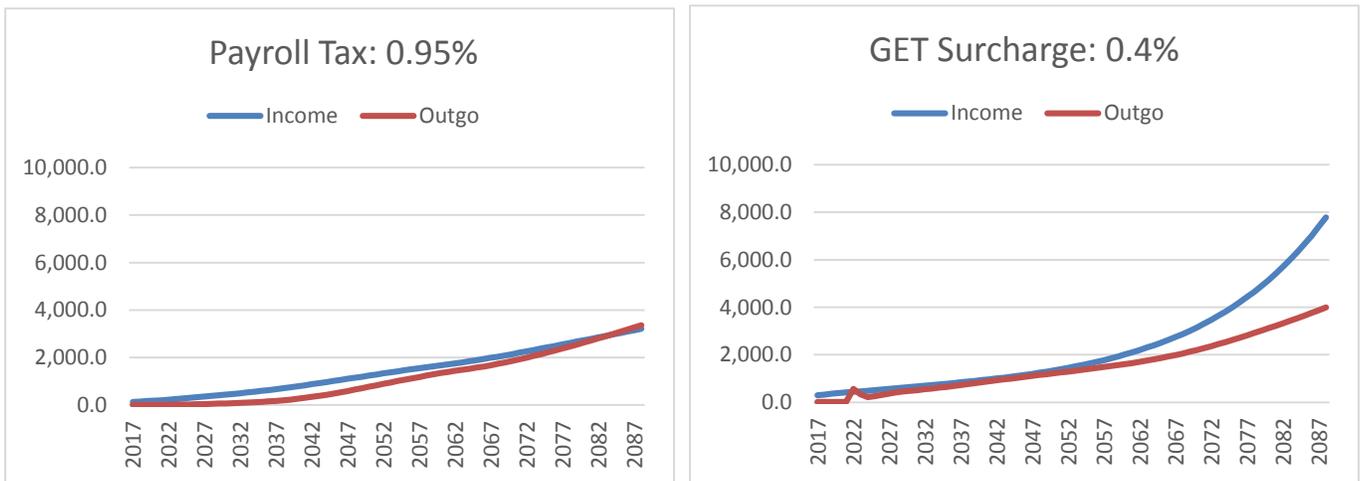
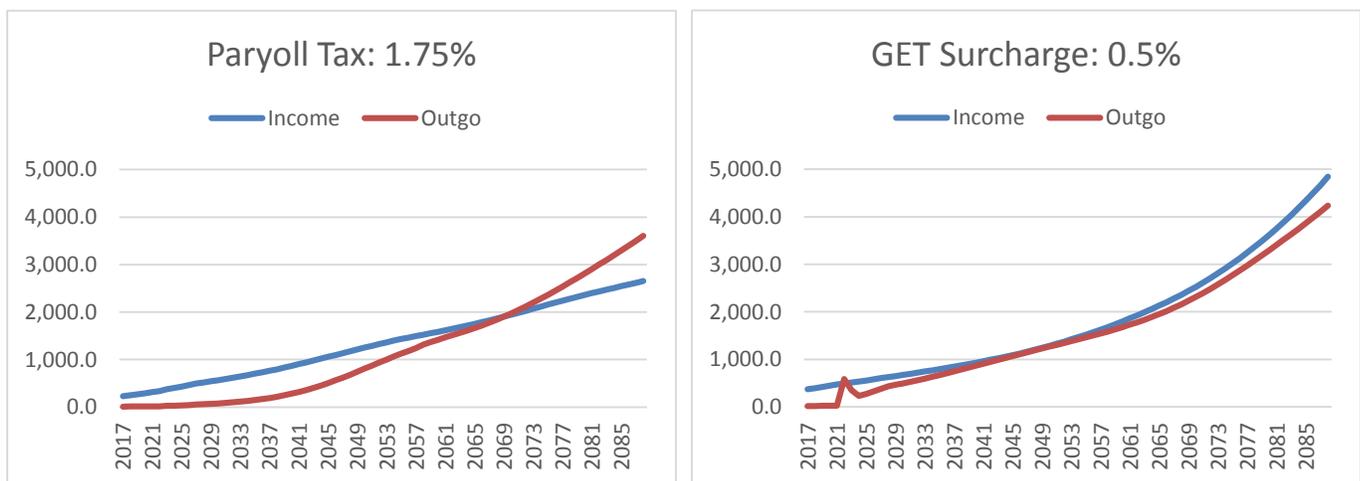


Figure 2: “Pessimistic” Economic Assumptions



¹ Calculations to determine fund solvency are based on an actuarial model developed by John Wilkin (F.S.A., M.A.A.A.) and Edward Armentrout, Actuarial Research Corporation, 6928 Little River Turnpike, Suite E, Annandale, VA 22003. Some sample models are available on the Hawai'i ADRC website: https://www.hawaiiadrc.org/site/439/reports_publications.aspx

In any scenario, the negative impact on poorer households will be larger than the impact of a GET surcharge. For those with household incomes of \$65,000, instead of paying a little over \$3,000 in GET, these households would be paying between \$7,500-\$15,000 in payroll taxes. Can this burden be shifted to higher income households by increasing the payroll tax and then reimbursing lower income households? This is certainly a possibility, but why not do that for a GET surcharge, especially considering the high levels of sustainability with a GET financing model?

4. How do we deal with the GET surcharge question(s)?

As demonstrated in Policy Note 9, the program is rather sustainable with a GET surcharge of 0.5%; even with the most pessimistic projections of the economy, a 0.5% GET surcharge can maintain a fund ratio of over 300% if the benefit cap is not increased by more than 3%, on average, annually. To offset the concern over regressivity, one possibility is to reimburse lower income households. Importantly, the fund looks sustainable with reimbursements directly from the fund, without a need to increase the 0.5% GET surcharge.

To examine this possibility, the average yearly expenditures of households in Hawai'i was examined. Various sources point to around \$55,000-65,000 for a household of three and \$60,000-75,000 for a household of four². Essentially, for household incomes below these values, the GET surcharge is flat; since all households earning below these values are spending their entire income on consumables, all households are paying the same proportion of their income on the GET³. Then, to determine whether a full reimbursement of the GET surcharge can be drawn from funds, the percentage of contributions to the GET tax base from households earning below these levels is estimated. Using the distribution of household incomes from the State of Hawai'i's Department of Business, Economic Development, and Tourism⁴, the approximate amount of spending by these income brackets was estimated by multiplying the "average" income of each bracket by the number of households in the bracket, under the assumption that households earning less than \$75,000 are spending their entire household income on consumption. The cumulative amount spent by different brackets was compared to the total GET tax base, and households earning less than \$75,000 contribute to less than 15% of the GET tax base.

Reimbursing 15% of the GET surcharge is certainly unsustainable, so two suggestions are provided. First, not all households earning less than \$75,000 need to be reimbursed; currently, tax credits are allowed for low income households to offset the impact of GET, and these credits only apply to households earning less than \$50,000. If reimbursements were (only) made to those earning less than \$50,000, this decreases to a reimbursement of approximately

² See <http://livingwage.mit.edu/counties/15003> and <http://quickfacts.census.gov/qfd/states/15000.html>. The average household size in Hawai'i is three, according to <http://quickfacts.census.gov/qfd/states/15000.html>

³ There is an argument to be made that households with incomes significantly below this level spend more than their household income on consumption by borrowing, and thus are taxed a higher percentage of their income compared to those within this income bracket, but for simplification, this is ignored.

⁴ http://files.hawaii.gov/dbedt/census/acs/ACS2014/ACS2014_5_Year/acs_hi_2014_geographic_5_yr/acs14_hi_5yr.pdf

6% of the annual tax intake for the program, a much more feasible amount. Secondly, the reimbursement does not need to cover the entire amount of the surcharge. The tax credits allowed for low income households to offset the impact of GET decreases at higher levels of household income; for example, households earning \$40,000-50,000 receive a credit of \$25 per adult⁵ and \$85 per child, compared to the approximately \$1,800 paid in GET. If this tiered reimbursement is applied, the total reimbursed will likely not exceed 1% of the annual tax intake for the program.

5. Conclusion

Recent discussions on funding a public LTSS program has raised concerns over the proposed GET surcharge, primarily the regressivity of such a tax. A GET surcharge is unquestionably more regressive than an income or payroll tax, so the question of the feasibility and impact of either an income or payroll tax is reasonable. As this policy note explained, there are problems that arise from using either income or payroll taxes that offset the benefit of being progressive or flat, mainly revolving around how to support current retirees. The payroll tax has an added problem of not being sustainable. The GET surcharge does not have any problems with distributing benefits to retirees, is highly sustainable, and the issues with regressivity can be easily addressed by allowing reimbursement of taxes to lower-income households. Due to the high fund ratios that come from a GET surcharge, this reimbursement can come directly from the program fund; even though the GET surcharge is more regressive than an income or payroll tax, such a funding model provides more flexibility and can be adjusted to limit, or even eliminate, the regressivity. Thus, if we are comparing the creation of a public LTSS program and examining funding mechanisms, there is a strong argument to use a GET surcharge instead of an income or payroll tax, despite its initial regressivity. If we then look at a public LTSS program funded with a GET surcharge versus not having a program in place at all, then the overall cost and benefits of the program should be examined, and with respect to regressivity, Policy Note 8 in this series has demonstrated that the program as a whole is progressive.

⁵ The credit actually only goes to household heads and adults that are considered dependents and who are not filing separately; using “adult”, however, overstates the amount of tax credit returned to the household. Credits by income bracket found on: <http://files.hawaii.gov/tax/forms/2014/n11ins.pdf>, page 33.

Bracket	Less than 10k	10-15k	15-25k	25-35k	35-50k	50-75k	Total
Number of households	26,234	15,737	33,050	34,310	53,049	83,008	450,299
FULL REIMBURSEMENT							
Bracket (value used for "average" calculations in parentheses)	Less than 10k (5k)	10-15k (12.5k)	15-25k (20k)	25-35k (30k)	35-50k (45k)	50-75k (65k)	GET base
"Average" income total	131,170,000	196,712,500	661,000,000	1,029,300,000	2,387,205,000	5,395,520,000	72,000,000,000
Share of base	0.001821806	0.002732118	0.009180556	0.014295833	0.033155625	0.074937778	
Bracket	Less than 10k	Less than 15k	Less than 25k	Less than 35k	Less than 50k	Less than 75k	
Cumulative	0.001821806	0.004553924	0.013734479	0.028030313	0.061185938	0.136123715	

TAX CREDIT							
Bracket (value used for "average" calculations in parentheses)	< 5k (2.5k)	5-10k (7.5k)	10-15k (12.5k)	15-20k (17.5k)	20-30k (25k)	30-40k (35k)	40-50k (45k)
Credit per adult; \$85 per child	85	75	65	55	45	35	25
Total credit (assuming 2 adults, 1 child)	255	235	215	195	175	155	135
"Average" spent on GET	100	300	500	700	1000	1400	1800
Percent credit on GET	255%	78%	43%	28%	18%	11%	8%
Number of households	13,117	13,117	15,737	23,135	27,070	33,070	37,134
"Average" income total	32,792,500	98,377,500	196,712,500	404,862,500	676,750,000	1,157,450,000	1,671,030,000
Share of base	0.0011614	0.0010703	0.001174811	0.001566432	0.00164488	0.001779809	0.001740656
Bracket	< 5k	<10k	<15k	<20k	<30k	<40k	<50k
Cumulative	0.0011614	0.0022317	0.003406523	0.004972955	0.0077427	0.00974267	0.01138299
Proportional credit for 0.5% surcharge	31.88	29.38	26.88	24.38	21.88	19.38	16.88

Full reimbursement example – less than 10k bracket:

For simplification, this was estimated in totals, as opposed to taking 4% of the total income to get GET paid by the bracket and 4% of the GET base to get total GET in the state
 26,234 number of households in bracket x \$5,000 average income per household for bracket = \$131,170,000 average income total
 We assume that all this income earned is spent on consumption, so to find the share this bracket makes up of the GET base,
 $\$131,170,000 \text{ average income total} / \$72,000,000,000 \text{ GET base} = 0.00182 \text{ share of base [you can multiply the share by 100\% to get the percent of the base (0.18\%)]}$

Tax credit example – 5-10k bracket:

To determine the effect of the credit, the populations within each tax credit bracket was estimated from the income distribution bracket as follows:
 5k & 5-10k are each 50% of the less than 10k bracket, the 15-20k bracket is 70% of the 15-25k bracket, the 20-30k bracket is 30% of the 25-35k bracket and 50% of the 25-35k bracket, 30-40k is 50% of the 25-35k bracket and 30% of the 35-50k bracket, and the 40-50k bracket is 70% of the 35-50% bracket
 Then, a total credit was estimated for a household based on a household of 2 adults and 1 child (lower income households are probably single adults, whereas those in the \$40-50k bracket might have more than 1 child). The “average” spent on GET was estimated, and then how much credit each household gets for each \$1 spent on GET was calculated. From there, the total “average” income was estimated (again, all income earned is spent on consumption). To get the credit received for the tax credit bracket, this “average” income total is multiplied by the percent credit on GET, and then taken out of the GET base to estimate the share of base.
 $\$75 \text{ credit} \times 2 \text{ adults} + \$85 \text{ credit} \times 1 \text{ child} = \235 tax credit
 $\$7,500 \text{ household income} \times 4\% \text{ GET} = \$300 \text{ average spent on GET}$
 $\$235 \text{ tax credit} / \$300 \text{ average spent on GET} = 78\% \text{ percent credit on GET (for every dollar spent on GET, the household gets 78\% back)}$
 $(13,117 \text{ households} \times \$7,500 \text{ average income} / \$72,000,000,000 \text{ GET base}) \times 78\% \text{ percent credit on GET} = 0.0010703 \text{ share of base}$

Proportional credit for 0.5% surcharge:

It doesn't follow to credit households the “total credit” for a 0.5% surcharge; this “total credit” offsets a 4% GET. To illustrate what a tax credit might look like for the 0.5% surcharge, the credit is scaled to the size of the tax. With a proportional credit, the 0.5% is 1/8 of the 4%, so the credit for the 0.5% surcharge should be 1/8 of the “total credit” for the 4% GET – instead of crediting \$235 (more) to a 2-adult, 1-child, 5-10k income household due to the 0.5% surcharge, the household would be credited \$29.38 (more).