CHAPTER 17

TAXING FOOD & MEDICAL CARE

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"Why should people have to pay a 4 percent excise tax on groceries and medical care?"

Forty-five states, including Hawaii, have a sales tax. Most of them exempt food purchased for consumption at home. But all food is taxed in Hawaii, and only Hawaii and New Mexico do not exempt most medical care.

Many people have criticized the fact that food and medical care are taxed in Hawaii. After all, food is a basic necessity, and it just doesn't seem right that people's medical misfortune would increase their tax burden. Quite frankly, it initially seemed rather heartless that Hawaii would tax food and medical care. A closer look, however, leads to a different conclusion.

Broad base. Hawaii's excise tax has many positive characteristics. Perhaps at the top of the list is the fact that it can generate so much revenue with such a low rate. It has a very broad base; practically nothing is exempt. The arguments for including food and health care in the excise tax base are the arguments for a broad base.

If food and medical care were exempted, many decisions by the legislature, department of taxation, and vendors would be necessary as to what qualifies as "food" and "medical care." For example, would membership in a health spa qualify as "medical care"? Could it ever? If you think that sounds silly, try writing a set of instructions that others could use to clearly and consistently distinguish medical care from other expenditures. Would "food" include chewing gum, dog food and soft drinks? Other states' efforts to deal with questions like these often are laughable. For example, in New York small marshmallows and plain peanuts are exempt, but big marshmallows and chocolate covered peanuts are taxable. If the exemption applies only to food for consumption at home (as is the case in most "exempt" states), is a salad bar at the grocery store taxable? The list of questions goes on and on.

Most studies have demonstrated that vendors make many mistakes because of ever-growing complexity, and take increasingly aggressive positions because of inherent ambiguity. From the State's standpoint, an exemption can be terribly difficult and expensive to administer. Ignore it and vendors develop a cynical attitude about "collecting" and paying the tax; actively police it and the cost quickly becomes burdensome.

More advantages. A broad-based sales tax is more likely to be horizontally equitable, meaning people with the same consumption will pay the same tax. A broad tax base requires people to bear the same tax burden if they spend the same amount of money, regardless of whether they get a face lift (medical care?), purchase gourmet food from a deli (food for home consumption?), or buy a new car (clearly something we want to tax). A household's tax burden should be determined by how much it buys, not what it buys.

Economists like the fact that a broad-based tax has less effect on what people buy. The tax does not influence a person's decision between going out to dinner or going to a movie as long as both are taxed, although the tax does reduce the amount available to spend on either option. Taxes are the cost of civilization and therefore necessary, but they should not make businesses compete on a tilted playing field.

Finally, and very importantly, a broad tax base allows a lower tax rate. This has many advantages, including that it discourages evasion. It may sound simplistic, but a low rate is probably the single most important component of a "good" tax.

The other side. The major argument for exempting food is to achieve greater equity. One estimate is that people earning less than $10,000 a year pay more than 4 percent of their income in excise taxes while those earning more than $40,000 pay less than 2 percent. Low-income people purchase more food relative to their income, so exemption of food would lessen the overall regressivity of the excise tax. Similar arguments might be made for exempting health care because many low-income people need relatively more medicines and medical supplies. Prescription medicine already is exempt from the excise tax.

Some health care services are provided by not-for-profit hospitals and agencies. However, this is not an acceptable reason for exemption since the tax is intended to be passed forward to the consumer.

Stalemate. Unfortunately, we seem to have a stalemate. Exemption of food and health care may improve one concept of fairness (the relative tax burden borne by high-income versus low-income people), but it does so at the expense of simplicity, efficiency and one aspect of equity (that people with the same consumption should pay the same taxes). Even proponents of a food and medical care exemption recognize it as a poor way of targeting low-income people for assistance. Low-income people might receive the greatest percentage reduction in their tax burden from exemption, but high income people would save more in absolute tax dollars. Consequently, most of the tax savings would not go to the intended group.

Fortunately, Hawaii has adopted a means of balancing all the competing concerns. Food and medical care are kept in the excise tax base, and the resulting problems are addressed by giving credits against the income tax. This approach implicitly assumes that equity is best achieved by ensuring that the burden of all taxes (as opposed to each tax) is fair. Addressing equity through the overall tax system, as Hawaii does, is a reasonable approach.

The credit approach enables the State to enjoy the benefits of a broad excise tax base and yet offset the resulting regressivity in a way that is simple and theoretically efficient. The cost of improving equity, in terms of lost tax revenues, is lower because equity is achieved by giving relatively more of the benefits to the target group. As a bonus, the broader-based excise tax is collected from both residents and nonresidents, but only residents receive the income tax credits.

Politicians sometimes are accused of taking stands calculated to gain them votes, even if those stands are flawed. With respect to the exemption of food and medical care from the excise tax, however, the State has taken an enlightened approach despite the fact that most voters probably do not understand this area well enough to appreciate its beauty. But that does not mean the current approach cannot be improved.

Ways to improve. Tax credits for food bear no direct relationship to actual excise-tax payments. They are a means of directly increasing the progressivity of the income tax, not of directly reducing the regressivity of the excise tax. Labeling credits invites lobbying for a host of other specific credits. Consequently, a single income-tax credit for low-income individuals, without any explicit attempt to tie it to the excise tax, would be an excellent way to improve tax equity in Hawaii.

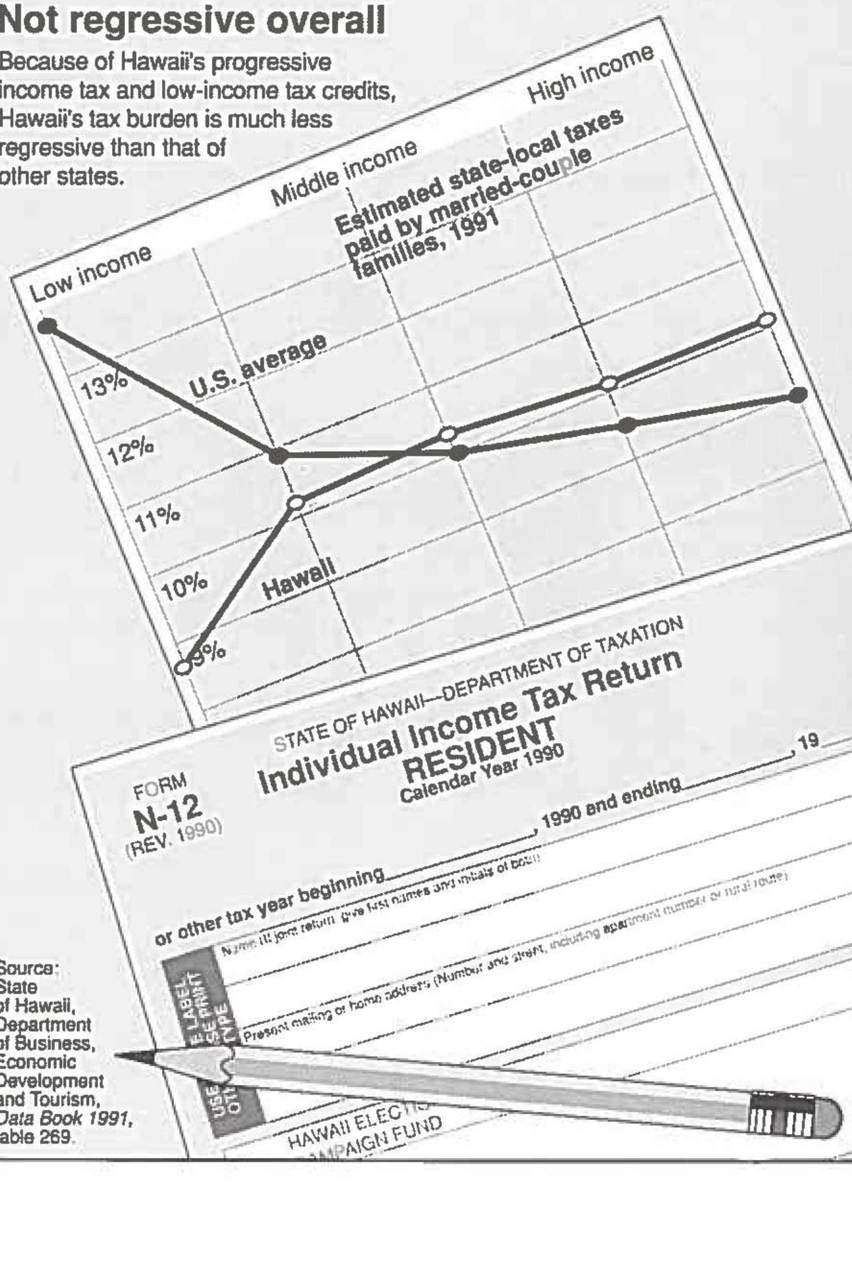
Hawaii's medical credits are linked to actual excise tax payments, so they directly reduce its burden and lessen its regressivity. They probably fail to achieve their intended purpose, however, since there is an upper limit to the tax credit. It does not help a person with a catastrophic illness any more than someone with a relatively minor ailment. A preferred medical credit would be one allowed only where unusually high medical costs are incurred. In other words, the opposite of what we have now.

Low-income people must file a return to receive the benefit of credits, but a significant number do not file. State tax officials must better inform low-income residents of the potential benefits of filing state income-tax returns.

The current approach of taxing food and medical care makes sense and is anything but heartless. If the people of Hawaii want a reduction in the amount of excise taxes they pay, it makes more sense simply to lower the tax rate than it does to exempt specific items.

Not regressive overall

Because of Hawaii's progressive income tax and low-income tax credits, Hawaii's tax burden is much less regressive than that of other states.



Source: State of Hawaii, Department of Business, Economic Development and Tourism, *Data Book 1991*, table 269.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