

Fiscal Impact Analysis of Exempting Military Retiree Pensions from State Income Tax

White Paper on Study Recommendations

Should the Commonwealth of Virginia exempt military retiree pensions from state income tax?

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Military Retiree Population Receiving Pension Payments



Source: DOD, Office of the Actuary

The Numbers:

With nearly 150,000 retirees, the Commonwealth of Virginia has the Nation's 3rd largest military retiree population; that represents approximately 7.5% of the national retiree population. These retirees generate nearly \$14.5 billion in annual household spending which supports nearly 80,000 jobs and over \$3.5 billion in wages across the state economy. With \$22.5 billion in total household income, retirees are responsible for contributing nearly \$900 million in annual tax revenue for the Commonwealth.¹

Why Consider Tax Breaks:

Given the significant economic and fiscal impacts (tax revenue) military retiree populations generate, it is no surprise states across the Nation are aggressively pursuing retirees with tax advantages with the hope of incentivizing them to relocate. In addition to the economic and fiscal impacts generated by them, military retirees also provide states with a highly trained workforce that helps attract or retain valueadded industries and the respective high wage jobs. However, implementing a tax exemption on military pensions as a means of attracting military retirees has not proven to be effective in states with large populations. Florida and Texas, both states that impose no income tax, have not experienced drastic growth in retirees. In fact, Florida has seen lower growth rates than the other high population states since FY 2005, indicating that for states with large retiree populations, income tax policy may not prove to be the most important factor in locational decisions of retirees.

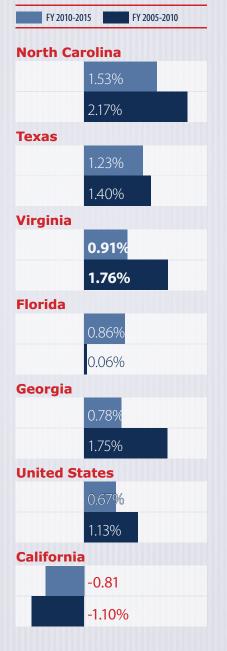
Doing Something Right:

The Commonwealth currently offers residents over the age of 65 personal deductions, but no income tax exemptions specifically for military pensions. This has not adversely affected retiree population numbers. In fact, since FY 2005, Virginia's military retiree population experienced an annual growth rate of 1.33%, significantly outpacing the national growth rate of 0.90%. The Commonwealth has even outpaced two peer competitors, Florida and California, and is on par with the state of Texas (recall Florida and Texas have no state income tax.) Virginia is outperforming peer states for many reasons. Most notably are access to high paying jobs, outstanding educational systems, wide variety of vibrant communities, and, the exceptional quality of living the state has to offer.

¹ These estimates are inclusive of indirect and induced economic and fiscal impacts associated with military retiree household spending. Please see the full fiscal impact study for assumptions, methodologies, and data sources.



Shifts in Annual Military Retiree Growth Rates



Source: DOD, Office of the Actuary

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How Much Will Tax Breaks Cost:

By exempting all military retiree pensions from state income tax, the Commonwealth would incur nearly \$145 million in foregone tax revenue during the first year of the policy – almost twice as much as the Secretary of Veterans and Defense Affairs FY 2017 budget.² It is estimated that retiree households generate approximately \$6,800 in tax revenue per retiree.³ A full tax exemption of pension income would result in a hit to state coffers of just over \$1,000 per retiree. That reduction in revenue would have to be balanced in the state budget, which translates to a drop in services or investment elsewhere.

In order for the tax exemption to be cost neutral, more retirees will need to relocate to Virginia than would otherwise have chosen to reside in the state. If the Commonwealth was to enact a tax exemption on all military pensions, and this policy resulted in increasing the annual growth from 1.33% to 1.50%, it would take approximately 22 years for the Commonwealth to recover the whole of its forgone tax revenue. With greater levels of retiree population growth, the payback period would obviously shorten.

Challenge in Attracting More Retirees:

Since FY 2010, the annual growth rates of net-new retirees nationwide have slowed from 1.13% to 0.67%. While a number of factors are driving the declining growth rates of military retirees, the primary driver is the continual reduction in the Nation's total force structure, which is at its lowest levels since before WWII.

Since the pool from which states can draw new retirees is declining at the nationallevel, state-level growth rates are also on the decline. With the exception of the marginal increases in Florida and California, the states with the highest retiree populations have all experienced slowing retiree growth rates – regardless of their income tax policy toward military pensions. In fact, North Carolina,⁴ a state that taxes most military pensions, continues to grow faster than Texas, a state that imposes no income tax.

Moving Forward:

The data suggest that generating the necessary growth rate to provide the tax exemption with a reasonable payback period will be difficult to obtain due to a number of factors, including: the declining number of net-new retirees each year, the relatively large impact to tax revenue the policy would create due to the already sizable retiree population residing in Virginia, and a multitude of other factors that contribute to the locational decisions of military retirees. The immense opportunities and nationally recognized quality of life elements make the Commonwealth highly desirable for retirees, even without a tax policy change on military retirement pensions.

² Commonwealth of Virginia, FY 2016 Executive Budget Document

³ Inclusive of indirect and induced economic and fiscal impacts.

⁴ As a result of the North Carolina Supreme Court's decision in Bailey v. State, North Carolina currently offers an income tax exemption on qualified state, local and military pensions for retirees that have five or more years of creditable service as of August 12, 1989.