

Fiscal Note

BILL # SB 1359

TITLE: veterans' income tax; exemption

SPONSOR: Rogers

STATUS: As Introduced

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Description

SB 1359 as introduced eliminates the cap on the tax exemption for military retirement pay. In tax year (TY) 2020, military retirees receiving pensions may subtract up to \$3,500 from their Arizona taxable income. SB 1359 would effectively reduce military retirees' income to \$0 (excluding other sources of income) for purposes of calculating their income tax liability, beginning in TY 2021.

Estimated Impact

We estimate that SB 1359 will decrease annual General Fund individual income tax revenues by \$(48.3) million beginning in FY 2022. However, if more military retirees are attracted to the state as a result of the exemption, the revenue reduction could be partially offset from additional tax collections to the General Fund.

Analysis

Military retirees with 20 years of service are eligible to receive pension payments from the federal government. Current law allows retirees to exempt up to \$3,500 of this pay from their Arizona adjusted gross income. In FY 2019, 53,959 Arizona residents received military retirement pay from the U.S. Department of Defense (DOD).

We first estimated the amount of military retirement pay that would be newly exempt from state income tax under SB 1359. DOD publishes annual data on total pension benefits received by Arizona military retirees. In FY 2019, Arizona beneficiaries received a total of \$1.54 billion in military pension payments, or an average pension benefit of \$28,500.

The most recent year for which DOD released national data on the distribution of payment amounts was FY 2018. We assume that this information also applies to FY 2019 payments, and that the distribution of payment amounts for Arizona military retirees is the same as that for all military retirees nationwide. For example, DOD data suggests that 1.8% of all military retirees nationwide receive \$3,500 or less in annual pension payments from DOD. Therefore, we assume that 1.8% of Arizona military retirees receive \$3,500 or less in annual pension payments from DOD.

Using this distribution data, we estimate that \$187.3 million in military pensions is already exempt under the current \$3,500 subtraction. SB 1359 would exempt an additional \$1.35 billion, or the remainder of Arizona military retirees' DOD pensions.

From FY 2014 to FY 2019, annual payments to Arizona military retirees grew by an average of 1.93% each year. At this growth rate, \$1.43 billion in military pensions would be newly exempt in FY 2022 under SB 1359.

Based on preliminary TY 2019 data, the average effective state individual income tax rate is 3.38%. Therefore, we estimate that SB 1359 will decrease annual General Fund revenues by \$(48.3) million beginning in FY 2022, which represents an average decrease in income tax payments per military retiree of \$880.

However, if increasing the exemption were to attract more military retirees to the state, the loss of revenues could potentially be offset from additional tax collections.

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A 2016 study by Dr. Joseph C. Von Nessen at the University of South Carolina theorizes that the gradual phase-in of a full tax exemption for military retirement pensions from TY 2016 to TY 2018 would lead to increased spending activity and net in-migration by military retirees, thus offsetting the loss of revenues to South Carolina. The study models the fiscal impact at 0% and 5% net in-migration rates. If South Carolina were to experience a 5% net in-migration rate of military retirees, the exemption would be revenue neutral by TY 2024. However, if South Carolina were to experience a 0% net in-migration rate, the exemption would result in a net revenue loss.

A second South Carolina study by Dr. Robert Carey at Clemson University in 2015 similarly theorizes that net in-migration could offset revenue loss and models the impact at four migration rates. The study concludes that a 0% or 1% net in-migration rate would result in net revenue loss, while a 2.5% or 5% rate would result in a positive impact to state revenues.

Academic literature is not definitive about the impact of increasing the income tax exemption on the relocation decisions of military retirees. According to Dr. Levi Pace at the University of Utah, "existing research is insufficient to predict the size of a possible migration response by military retirees due to an income tax policy change."

For illustrative purposes only, we calculate the impact of greater military retiree in-migration. From FY 2014 to FY 2019, the number of military retirees in Arizona grew by an average of 0.61% each year. If this growth rate were to increase to 1.00% in the first year, FY 2022, and then in increments of 0.50 percentage points each year thereafter, approximately 13,500 additional retirees would have moved to Arizona by FY 2030.

These additional retirees could result in state revenues through sales tax collections and income tax payments from other sources. Transaction privilege tax and individual income tax revenues per resident filer are projected to grow to nearly \$3,800 in FY 2022 and \$5,100 in FY 2030. We estimate that SB 1359 would exempt, on average, \$880 in income tax liability for each retiree in FY 2022, which would grow to \$970 for each retiree in FY 2030. As a result, average revenues per additional military retiree will be approximately \$2,900 in FY 2022 and \$4,100 in FY 2030.

Under these assumptions, the net in-migration of additional military retirees through FY 2030 would generate an additional \$55.5 million in revenue that year, when the military retiree growth rate reaches 5.0%. In FY 2030, the direct loss in revenues from eliminating the exemption cap would be \$(56.2) million due to growth in the number of additional retirees receiving the exemption.

In this scenario, the approximate break-even point would occur in FY 2030, when the direct loss in revenues to the General Fund would be roughly offset by the migration of additional military retirees to Arizona.

New retirees could also result in additional expenditures for state-provided services.

Local Government Impact

Each year, incorporated cities and towns receive 15% of income tax collections from 2 years prior. SB 1359 would decrease annual local government distributions by \$(7.2) million beginning in FY 2024. This amount excludes any possible gains from additional retirees moving to these jurisdictions, such as transaction privilege tax revenues.