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## **Rethink tax relief based on age alone**

Each Southern state should redesign tax codes to provide fair tax treatment to seniors so benefits are based on *ability-to-pay* instead of age alone.

### **Background**

All Southern states offer preferential<sup>1</sup> tax treatment to senior citizens who are 65 and older. The most common strategies include income tax exclusions for Social Security and pension income, higher standard deductions or personal exemptions for income taxes, and property tax breaks, such as higher homestead exemptions.

**Typical senior *tax preferences* include tax exclusions, higher tax deductions and property tax breaks.**

These tax relief measures generally were adopted at a time when the South's elderly population was smaller and

more likely to be poor than today. Significant improvements to the socioeconomic well-being of senior citizens, coupled with the upcoming retirement of the baby boomer generation, have called into question the wisdom of such tax relief measures. Southern leaders should revisit state tax *preferences* targeted to seniors to ensure they still achieve worthy policy goals, generate an adequate flow of revenues and treat all taxpayers fairly.

**Figure 1: Select senior tax preferences in Southern states**

State	Full exemption of Social Security income	Private pension exemption	Added exemption or higher standard deduction	Property tax benefits
AL	X	X		X
AR	X	X		
FL	N/A	N/A	N/A	X
GA	X	X	X	X
KY	X	X		X
LA	X	X	X	
MS	X	X	X	X
NC	X	X	X	X
SC	X	X	X	X
TN	N/A	N/A	N/A	X
VA	X		X	X

Note: FL and TN have no personal income tax. Source: Center on Budget and Policy Priorities

## Tax preferences for seniors in the South

Along with savings and investment, two major sources of retirement income are Social Security and pensions. Workers contribute to the federal Social Security program throughout their careers by having a portion of each

paycheck go to the Social Security Administration. Upon retirement, workers receive Social Security payments from the federal government based on their earnings over the years. In addition, many retirees receive pension payments from past employers.

Southern states provide special tax treatment to both sources of retirement income, as shown in Figure 1.<sup>2</sup> Each of the nine Southern states with an income tax fully exempt Social Security benefits, and eight states exempt some or all private pension income. In addition, six states offer seniors a higher personal exemption or standard deduction on income taxes. For example, taxpayers over age 65 in Mississippi receive an extra \$1,500 exemption on income taxes. Seniors also receive preferential treatment on property taxes in every Southern state except Arkansas and Louisiana.

**Special tax treatment for seniors creates inequities between elderly and non-elderly taxpayers.**

## **Is there a need for special treatment?**

Senior tax relief measures were adopted decades ago “when elder poverty was much more widespread in the United States than today” and “it seemed reasonable ... for states to attempt to relieve the tax burden on the elderly.”<sup>3</sup> Since the creation of these relief tools, broad social and economic changes have occurred nationally and the condition of seniors is not what it once was. Poverty among seniors has declined sharply over the past 30 years. According to the U.S. Census Bureau, the national proportion of seniors living in poverty declined from 24.6 percent in 1970 to 10.2 percent in 2003—a lower rate

than the poverty rates of either children or non-elderly adults.<sup>4</sup> When compared to historical counterparts, today's seniors generally have higher incomes and greater wealth.<sup>5</sup>

Such trends mean state tax relief measures based on age alone are not necessarily targeting those taxpayers in need anymore. Consider a tax break that goes to all seniors, regardless of *ability-to-pay*. A senior with \$100,000 can receive the tax break, while a non-senior making \$20,000 does not. Since the senior *tax preferences* are based on age rather than need, they shift the tax obligation to non-elderly, including low-income non-elderly taxpayers. These senior tax breaks can even create distortions between taxpayers of similar income since the measures are often based on age alone.

**Figure 2: Average effective income tax rates in Virginia, 2002**

Income Range	Effective Income Tax Rate	
	Seniors	Non-Seniors
All Income Groups	1.29%	2.99%
\$0 to \$20,000	0.01%	1.08%
\$20,000 to \$30,000	0.26%	2.90%
\$30,000 to \$50,000	0.64%	3.57%
\$50,000 to \$100,000	1.93%	4.01%
\$100,000 to \$200,000	3.28%	4.43%

Source: Georgia State University<sup>6</sup>

Figure 2 offers an illustration of how senior *tax preferences* create inequities between the elderly and non-elderly. As shown, seniors in Virginia experienced a lower effective tax rate than non-seniors at every income level studied in 2002.<sup>7</sup> Effective tax rates are the actual tax rates experienced by a taxpayer. For example, the income tax rate might be 6 percent, but after exemptions and credits, the effective, or real, tax rate that a taxpayer actually experi-

ences is 3 percent. Since 2002, Virginia has scaled back some of the senior tax exemptions for wealthier seniors and the effective tax rate should be closer for higher income seniors and non-seniors.

### Is there a cost?

The need for senior tax relief has changed over time. So has the cost. A recent study by the Center on Budget and Policy Priorities, a think tank in Washington, D.C., estimated the cost of senior *tax preferences* in four Southern states: Kentucky, Louisiana, Mississippi and North Carolina (Figure 3).<sup>8</sup> *Tax preferences* for pension income and Social Security benefits cost the four states approximately \$1 billion. The cost ranged from \$12.6 million in Louisiana to \$494 million in North Carolina. When expressed as a share of general fund revenues, the cost was relatively small in Louisiana, but much higher in the three other states. In Mississippi, for example, the cost of senior *tax preferences* equaled 5.2 percent of general fund revenues.

**Figure 3: Cost estimates for select senior tax preferences, Southern states**

State	Estimate year	Pension preference	Annual cost (millions)	Social Security preference	Annual cost (millions)	Total of available estimates	% of general fund revenues
KY	2004	X	\$235.1	X	\$71.6	\$306.7	4.3%
LA	2004	X	\$12.6			\$12.6	0.2%
MS	2005	X	see note	X	\$203.3	\$203.3	5.2%
NC	2004	X	\$314.8	X	\$179.2	\$494.0	3.4%

Note: Cost of pension preference in MS is included in cost of Social Security preference. Source: Center on Budget and Policy Priorities

The cost of special tax treatment for senior citizens likely will increase along with the anticipated growth of the nation's elderly population. By 2030, according to Census Bureau projections, 20 percent of all Americans will

be at least age 65 or older.<sup>9</sup> The South will be especially affected by society's aging, as Southern states have experienced some of the nation's largest percentage increases in senior citizens.<sup>10</sup> By 2030, the share of each Southern state's population that is age 65+ will range between 27.1 percent in Florida and 15.9 percent in Georgia (Figure 4).

**Figure 4: Percent of population age 65+, 2005 vs. 2030, South**

State	2005 Population	2030 Population
AL	13.3	21.3
AR	13.8	20.3
FL	17.2	27.1
GA	9.6	15.9
KY	12.5	19.8
LA	11.9	19.7
MS	12.2	20.5
NC	11.9	17.8
SC	12.5	22.0
TN	12.5	19.2
VA	11.5	18.8

Source: U.S. Census Bureau

With more seniors, there will be more taxpayers taking advantage of senior *tax preferences*. In Mississippi, for example, the cost of senior *tax preferences* is expected to jump from 5.2 percent of general fund revenues to 9.3 percent, based on 2004 costs with the projected 2030 senior population. Kentucky, meanwhile, will see its costs rise from 4.3 percent of general fund revenues to an estimated 7.5 percent in 2030.<sup>11</sup> A study of Georgia's tax system found that senior income *tax preferences* would lower income tax collections by 3 percent every year from 2000 to 2005. The loss in revenue would double after 2005, and Georgia would lose 6 percent of income tax revenues to senior *tax preferences* every year from 2005 to 2015.<sup>12</sup> Simi-

larly, Virginia would lose 5.3 percent of income tax collections every year from 2005 to 2015 because of senior income *tax preferences*.

**The cost of special tax relief for senior citizens likely will increase in the South as the region is expected to add millions of elderly residents in the next 26 years. If state leaders continue to provide such *tax preferences*, the burden on state budgets will dramatically rise.**

While these states are losing potential revenue due to an increased senior population, they will also likely experience increased costs of services used by seniors. These services include Medicaid, departments of aging and health care costs for retired state employees. One recent study of these three areas in North Carolina found that applying current spending levels to the estimated elderly population in 2030 would require an additional \$2.7 billion in state spending.<sup>13</sup>

### **Seniors: Boon or drain on state coffers?**

The unprecedented demographic shifts remaking the nation and region have left analysts and public officials unsure of the impacts an aging society will have on state coffers. Some argue a large elderly population will drain state resources because of the high levels of medical care demanded by elderly residents and the fact that many seniors no longer work. Other observers look at the aging of society as a positive development because seniors tend to have higher levels of net worth and little need for expensive public education.



The truth likely lies somewhere in between and depends on the size, proportion and composition of a state's elderly population.<sup>14</sup> Younger seniors (ages 65-74) tend to be healthier than older peers and have higher incomes and greater wealth. A population with many younger seniors may actually be a benefit from a state fiscal perspective. The situation changes for older seniors, especially those over the age 85. Older seniors tend to be in worse health, have lower incomes and have less wealth as a result of having spent down their savings in retirement.

Consider net worth. In 2000, the median net worth of households headed by an individual older than age 65 equaled \$108,885. Households headed by a senior between the ages of 65-69 had a median net worth of \$114,000, compared to a median net worth of \$100,100 for households led by someone over the age of 75. Regardless of age, however, most of a senior household's wealth is tied up in housing equity. When housing wealth is excluded, the median net worth of elderly drops to \$23,369.<sup>15</sup>

Observers who argue seniors are beneficial to state coffers often say senior tax exemptions and other incentives targeted to older adults should be used to attract seniors into a state. Studies, however, consistently find “most older people do not move” and that roughly half of all elderly movers remain in the same county.<sup>16</sup> If policymakers wish to benefit from the perceived positive demographic characteristics of elderly citizens, they may want to focus on attracting younger workers who then will remain in the area for retirement and “age in place.”<sup>17</sup> This means investing in the amenities—such as affordable housing, good infrastructure and high quality schools—valued by younger workers who likely have school-aged children.

## Better ways to help seniors

If the purpose of tax breaks for seniors is to alleviate poverty among the elderly, current benefits miss the mark. Because age and poverty are no longer inextricably intertwined, many existing senior tax advantages flow to older taxpayers with high incomes. As a consequence, the tax obligation shifts to non-seniors, including low-income taxpayers.

**If the purpose of special tax treatment for seniors is to alleviate poverty among the elderly, current benefits miss the mark.**

To restore balance and help the intended beneficiaries, states should provide tax benefits on the basis of income rather than age alone. As an added bonus, income-based preferences would benefit non-elderly lower-income households. While the exact policy changes would depend on each state's tax code, five general options appear worthy of consideration:<sup>18</sup>

- **Social Security.** States should consider adopting the federal standard for the taxation of Social Security income or limiting the Social Security exemption to taxpayers within certain income ranges. The federal government starts taxing Social Security for individuals with combined income over \$25,000 and for couples with income over \$32,000. Connecting tax relief to income ensures benefits go to those seniors who truly have a limited *ability-to-pay*.

- **Pension income.** States should establish income limits for the exemption of pension income. Virginia, for example, recently changed its tax code to phase out the pension exemption for single taxpayers with incomes of more than \$50,000, and for joint filers with incomes above \$75,000.
- **Age-based exemptions.** States might want to convert age-based personal exemptions to higher standard deductions available to all ages. This reform would provide more relief to low- and moderate-income taxpayers regardless of age.
- **Property tax benefits.** States could link property tax benefits to income-based criteria (e.g. circuit breaker program; see Idea 9).
- **Eligibility Age.** States should consider setting the eligibility for age-based *tax preferences* above the age of 65. For example, people older than age 75 are more likely than those between 65-74 to be poor, so a preference designed to alleviate poverty might be more effective if set at an older age.

While reforming senior *tax preferences* might appear politically impossible, Virginia made progress in 2004 as part of a larger statewide tax reform package. State lawmakers in Virginia reduced senior tax breaks by phasing out income tax exemptions going to seniors with income of \$50,000 for singles and \$75,000 for couples. The senior tax reforms gained the support of leaders from both political parties as well as the AARP.<sup>19</sup>

## Revisit senior tax relief measures

States adopted preferential tax treatment for senior citizens when senior citizens were more likely to be poor than today's seniors. As a result, benefits now go to many unintended senior taxpayers who qualify on age rather than income. The conditions of seniors have changed, yet the *tax preferences* have remained the same or even grown in certain states.

To ensure that tax benefits go to senior taxpayers truly in need, states should revisit how they give tax relief to seniors and tailor specific measures for seniors in the 21<sup>st</sup> century. *Fairness* in taxes should not be based on age alone, but rather, on *ability-to-pay* among taxpayers of any age.

## Talking points

- Through the years, states adopted specific measures to provide favored tax treatment to seniors to help them, in part, get out of poverty.
- But over the years, the senior population has changed. Not as many seniors are in poverty. In fact in recent years, seniors have had a lower poverty rate than children and non-senior adults.
- It makes common sense to review tax breaks for seniors to see if they're still needed. And if they are, they should be provided on *ability-to-pay*, not just because they're older taxpayers.

## Endnotes

<sup>1</sup> For purposes of the discussion in this chapter, the term “tax preference” should be viewed as synonymous with “tax-favored treatment.” It should not be confused with specific meanings associated with the federal Alternative Minimum Tax.

<sup>2</sup> Author’s analysis of data contained in Elizabeth McNichol, “Revisiting State Tax Preferences for Seniors” Washington, D.C.: Center on Budget and Policy Priorities, March, 6, 2006.

<sup>3</sup> McNichol (2006), p. 2.

<sup>4</sup> Wan He, Manisha Sengupta, Victoria Velkoff and Kimberly DeBarros, “65+ in the United States: 2005.” Washington, D.C.: U.S. Census Bureau, December 2005, p. 103.

<sup>5</sup> *Ibid.*, pp. 100 and 109.

<sup>6</sup> Edwards, Barbara and Sally Wallace. “How Much Preference: Effective Personal Income Tax Rates For The Elderly.” Georgia State University, Fiscal Research Center. FRP Report No. 70. April 2002, p. 27.

<sup>7</sup> *Ibid.*

<sup>8</sup> McNichol (2006)

<sup>9</sup> He (2005), p. 1.

<sup>10</sup> *Ibid.*, p. 119.

<sup>11</sup> McNichol (2006), p. 20.

<sup>12</sup> Edwards (2002)

<sup>13</sup> Amna Cameron, “Tax Retirement Income? The Impact of Population Shifts on State Revenue and Spending.” Raleigh, N.C.: North Carolina Budget and Tax Center, 2006.

<sup>14</sup> He (2005), 123.

<sup>15</sup> *Ibid.*, p. 109.

<sup>16</sup> *Ibid.*, pp. 138 and 140.

<sup>17</sup> William Frey, “Elderly Demographic Profiles of U.S. States: Aging-in-Place, Migration and Immigration Impacts.” Ann Arbor, M.I.: Population Studies Center at the University of Michigan, March 1995.

<sup>18</sup> These recommendations are adapted from McNichol, p. 21.

<sup>19</sup> Greenblatt, Alan. “Solidarity on Solvency.” *Governing*. November 2004. 24-25.