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## FISCAL IMPACT REPORT

ORIGINAL DATE 02/08/11

SPONSOR McMillan LAST UPDATED 02/18/11 HB 265

SHORT TITLE Military Retirement Income Tax Exemption SB \_\_\_\_\_

ANALYST Burrows

### REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	FY12	FY13		
	(\$11,710.0)	(\$23,880.0)	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicate to SB 217

### SOURCES OF INFORMATION

LFC Files

NMSU Arrowhead Study

#### Responses Received From

Taxation and Revenue Department (TRD)

Veterans Services Department (VSD)

Economic Development Department (EDD)

Department of Military Affairs (DMA)

#### Other Responses

Military Officers Association of America (MOAA)

### SUMMARY

#### Synopsis of Bill

House Bill 265 would allow military retirees or surviving spouses an exemption of 100 percent of retirement or retainer pay that would be includable in net income for purposes of calculating personal income tax liability. The exemption would be effective for tax year 2012 and beyond.

### FISCAL IMPLICATIONS

According to the U.S. Department of Defense, as of 2009, there were 21,385 retired military personnel living in New Mexico, including 20,188 receiving \$518.8 million in retirement benefits, and 2,707 surviving spouses receiving an additional \$36.9 million. The average benefit was thus \$23,066 per individual.

The revenue estimate is derived by increasing the number of military retirees by 1.5 percent per year (the historical growth rate of New Mexican military retirees, according to the Arrowhead study) and raising the average annual benefit by 1.6 percent in tax year 2010 and 2.5 percent (the average 10-year change in the consumer price index) from tax year 2011 forward. According to the Arrowhead study, the average household income for retired military personnel residing in New Mexico is approximately \$86,000. Therefore, military retirement pay is assumed at an average marginal tax rate of 4%. Although the household income of surviving spouses may be much less than that of military retirees, even at the state average of \$56,000 (as stated in the Arrowhead study), the marginal tax rate is approximately 4%. The revenue impact in a given year is calculated as the product of the number of retirees plus surviving spouses, the average annual benefit, and an average marginal tax rate of 4%.

NMSU conducted a study that yielded very different and lower results. The central assumption is the rate applied to income for the purposes of calculating income tax. The LFC analysis uses a *marginal* tax rate, which is the rate that would be applied to the last dollar of adjusted gross income. NMSU used an *average* rate of total New Mexico personal income taxes divided by total New Mexico personal income. The NMSU rate includes individuals at lower tax brackets than the average retired military personnel, which lowers the effective tax rate. The marginal rate used in the LFC analysis is double the rate used by NMSU, thus increasing the amount of the exemption. The LFC analysis also includes surviving spouse benefits, which further adds to the fiscal impact.

Proponents of the bill suggest that this proposal could attract new military retirees to the state, which could offset revenue losses, and result in positive revenue impacts in future years. These positive effects would result from the influx of federal dollars in the form of GI Bill tuition benefits, VA disability benefits, and Social Security income, as well as the increase in gross receipts revenue and other tax revenues if these funds are spent in New Mexico. Without further data, the potential impact of additional retirees cannot be calculated with any degree of certainty. Including a sunset provision could allow time to assess the benefits of the bill.

## **SIGNIFICANT ISSUES**

The Albuquerque chapter of Military Officers Association of America (MOAA) presented its own analysis of the benefits of exempting retirement pay. In its analysis the group reported that it was in the best interests of the state to attract retirees, because they would bring with them federal benefits such as Tri-Care health coverage and retirement income. MOAA also suggests that military retirees can provide New Mexico with increased human capital assets, and additional revenue through a multiplier effect, with little or no impact to social services. The report also emphasizes the benefit to the New Mexico labor force of military retirees in education, medical services and business. In 2009, legislation was passed to allow military veterans to receive in-state tuition in New Mexico. This bill would provide added incentive for military retirees to relocate to the state.

According to the Economic Development Department, tax incentives for military retirees could encourage military personnel currently stationed in New Mexico to remain in the state upon retirement.

In 2008, Senate Memorial 27 was passed, which led to the establishment of a NMSU taskforce to study the economic benefit of providing a tax exemption to military retirees. The taskforce,

made up of representatives from TRD, Economic Development Department, MOAA, veteran's organizations, and military widows, met over the interim and discussed the possible benefit of enacting an exemption.

NMSU reports that New Mexico has a fairly high share of veterans already. Citing data from the Department of Defense, the study reports veterans as a percent of population for NM was 1.08 percent in 2007, much higher than the national average of 0.66 percent. Further, at the time of the study, states with no income tax or with tax exemptions for military pay had lower shares of retired military personnel, except for Alabama and Hawaii (see Attachment 1).

According to the Arrowhead study, Wisconsin enacted a similar bill in January 2001. The population growth rates of military retirees in Wisconsin have shown strong positive growth since 2001. However, population growth rates were not available for Wisconsin military retirees prior to 2001, so it is impossible to measure the true impact of the legislation.

### **OTHER SUBSTANTIVE ISSUES**

According to TRD, individuals with incomes and other circumstances similar to individuals receiving the proposed exemption are likely to view the exemption as unfair, especially if they have to compete with retirees for jobs. Moreover, since retirees have relatively large incomes, some may consider the additional benefit as unnecessary, and thus unfair.

Moreover, the exemption may require other taxpayers to pay higher taxes to offset the reduction in the tax base, unless comparable spending cuts are made.

TRD also reports that the proposed exemption might encourage military retirees to move to New Mexico. These retirees may possess substantial work skills that could benefit New Mexican economic development efforts.

According to the Arrowhead study, an additional 1,606 military retirees must move to the state to offset the revenue lost in the first year. This calculation assumes all gross receipts revenue generated from the newcomers goes to the state. If the distribution to local governments is taken into account, an additional 2,243 military retirees would be needed to offset the loss to the general fund. However, the study estimates a much lower revenue impact (a loss of \$8 million) than this analysis because of differences in assumptions as outlined above. As such, the number of military retirees who would need to relocate to New Mexico to offset the loss to the general fund may be much greater.

### **ALTERNATIVES**

Development efforts that aim to attract businesses to the state may be more cost-effective, because they can provide jobs to *current* New Mexico residents.

### **WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL**

If House Bill 265 is not enacted, military retirees and surviving spouses will not receive an income tax exemption for military retirement pay and surviving spouse benefits.

***The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:***

- 1. Adequacy:*** revenue should be adequate to fund government services.
- 2. Efficiency:*** tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.
- 3. Equity:*** taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.
- 4. Simplicity:*** taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.
- 5. Accountability/Transparency:*** Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.

***More information about the LFC tax policy principles will soon be available on the LFC website at [www.nmlegis.gov/lcs/lfc](http://www.nmlegis.gov/lcs/lfc)***

<b>Veterans as a Percent of Population by Tax Status</b>				
	Number of Retired Veterans Receiving DOD Payments	US Population from the US Census	Veterans as a Percent of the Population	Tax Status
Hawaii	15,701	1,283,388	1.22%	Military pay exemption
Alabama	53,982	4,627,851	1.17%	Military pay exemption
<b>New Mexico</b>	<b>21,274</b>	<b>1,969,915</b>	<b>1.08%</b>	-
Florida	186,102	18,251,243	1.02%	No income tax
North Carolina	82,050	9,061,032	0.91%	Military pay exemption
Mississippi	25,574	2,918,785	0.88%	Military pay exemption
Texas	183,005	23,904,380	0.77%	No income tax
Kansas	20,281	2,775,997	0.73%	Military pay exemption
<b>United States</b>	<b>1,983,467</b>	<b>301,621,157</b>	<b>0.66%</b>	-
Kentucky	25,945	4,241,474	0.61%	Military pay exemption
Louisiana	25,524	4,293,204	0.60%	Military pay exemption
Pennsylvania	48,053	12,432,792	0.39%	Military pay exemption
Ohio	43,479	11,466,917	0.38%	Military pay exemption
Wisconsin	18,944	5,601,640	0.34%	Military pay exemption
Massachusetts	19,164	6,449,755	0.30%	Military pay exemption
Illinois	34,779	12,852,548	0.27%	Military pay exemption
Michigan	27,234	10,071,822	0.27%	Military pay exemption
New Jersey	20,419	8,685,920	0.24%	Military pay exemption
New York	36,884	19,297,729	0.19%	Military pay exemption

Source: NMSU Arrowhead study