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REVISITING STATE TAX PREFERENCES FOR SENIORS

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Summary

By the year 2030 one in five Americans will be over the age of 65 according to Census Bureau projections. Increasingly, state budgets will be stretched thin by the healthcare and other needs of the nation's elderly. For example, states provide on average 47 percent of the funding for the Medicaid program, which pays for the vast majority of long-term care in this country and bears a portion of the prescription drug costs for low-income elderly people. States must finance pensions and health care for what will be a growing cadre of retired state employees. Elderly-related costs borne by state and local governments for a range of other programs ranging from special transportation to social services will also be increasing.

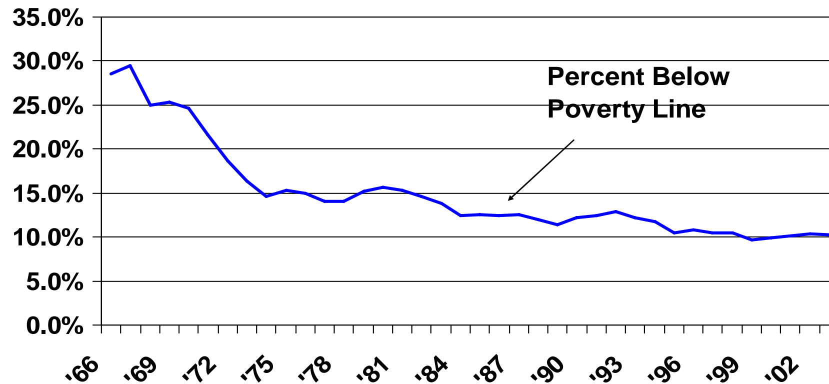
While these government costs will be rising, the revenue collections needed to cover the costs will be depressed in many states as the proportion of elderly in the population increases. This is because states provide a wide variety of income and property tax breaks to all elderly residents — regardless of their income. The cost of these special tax preferences will rise along with the increase in the elderly population. These preferences are widespread.

- Some 28 states completely exempt social security income from the income tax.
- Pension income is fully or partially exempt from taxation in 33 states.
- Nine out of ten states offer added income tax exemptions, standard deductions, or credits based on age.
- In addition, many states assist local governments with the costs of age-based property tax reduction programs. Some 26 states offer homestead exemptions or credits targeted to the elderly.

Data on the cost of at least some of these preferences is available for 22 states. Currently, the cost exceeds three percent of the state's general fund budget in nearly one-third of these states (Illinois,

FIGURE 1

Percent of Elderly in Poverty Has Declined Significantly



Source: U.S. Census Bureau, Current Population Survey

Kentucky, Michigan, Mississippi, New York, North Carolina, and Pennsylvania). By 2030, the cost will grow to exceed three percent of the budget in three-fifths of these states. (The additional six states are Delaware, Idaho, Iowa, Missouri, Oklahoma, and Oregon.)[1] In four of the 22 states, the costs would exceed seven percent of the budget.

Decades ago, when many of these preferences were first established, elder poverty was much more widespread in the United States than today. In 1970, some 25 percent of the over-65 population had below-poverty income. It seemed reasonable at that time for states to attempt to relieve the tax burden on the elderly. Today, however, only 10 percent of the elderly are poor. (See Figure 1.) As a result, many state tax preferences for seniors that have long been in state tax codes now benefit taxpayers who have similar or better ability to pay taxes as other segments of the population. This raises questions about whether these tax preferences for the elderly make sense in the current context.

Moreover, in many states the special tax preferences do not help the lowest-income seniors. In states that generally do not tax people with incomes below or slightly above the poverty line, most of the special tax preferences for seniors are used only by somewhat higher income taxpayers. In states that levy their income tax with multiple rates that increase with income, it is the highest income seniors who benefit most from the preferences.

By better targeting income and property tax reductions on low-income seniors, states can free resources to pay for the growing needs of senior citizens while still assisting poor elder residents.

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[1] There is little information collected on a regular basis on the cost of senior tax preferences to states. These estimates in are based on the costs of *income tax* preferences using information from state tax expenditure reports.

AARP's Policy Director Addresses Issue of Non-targeted Breaks for Seniors

John Rother, AARP's Director of Policy and Strategy, made the following statement, "While surveys reveal many Americans feel they are overtaxed, US tax burdens are lower today than their average for the past several decades, and significantly lower than those in most developed countries. Tax relief is warranted for people who confront difficulties in meeting living expenses, but it is difficult to justify preferential treatment on age grounds alone or on the basis of receiving pension income. Property taxes are the least popular form of tax, especially in light of their recent escalation, and can pose significant problems for older persons wishing to remain in their homes.

"With the population aging and more people needing services, younger people, many of whom are struggling financially, will not be able to fill the revenue gap. Older Americans, who are the beneficiaries of so much of what government provides, understand this and the need to do their part."

AARP is a nonprofit, nonpartisan membership organization of over 35 million people age 50 and older.

- More states could tax a portion of social security benefits when the recipient's total income exceeds a specified amount — as the federal government does — rather than completely exempting social security income from taxation. Currently 12 states use the same income limits as the federal government for determining whether to tax social security benefits.

- States that offer exemptions for public or private pensions could phase them out at a specific income level or only offer them to taxpayers with incomes below a certain level. For example, as a part of a large tax package adopted in 2004, Virginia scaled back its preferential treatment of pension income by allowing the exemption to phase out for taxpayers at higher income levels.

- States could convert their age-based additional personal exemptions to a higher standard deduction, comparable to the one the federal government offers. This would target these preferences more to lower and middle income taxpayers.

- Additional states could rely more on means-tested property tax credits rather than homestead exemptions or credits. For example, under the provisions of credits known as "circuit-breakers" taxpayers receive a credit if their income is below a defined level and their property taxes exceed a specified percentage of their income. Currently, 34 states offer property tax circuit breaker programs; many of these are very limited programs, however, and some of the same states also offer homestead exemptions or credits that are not means-tested.

- States could raise the eligibility age for their age-based credits and exemptions in order to target them on the seniors who have less ability to pay. The percent of people 75 years old and older in poverty is higher than the percent of those between 65 and 75 in poverty (although the rates are still considerably below senior poverty rates of the past).

As states prepare for the spending challenges that the aging of the population will bring they should consider the revenue challenges as well. The time for states to reconsider their senior tax preferences is now, before the baby boom generation retires and the cost of the preferences begins to rise rapidly and it therefore becomes even more politically difficult to modify them.

Designing Change to Improve Chances of Adoption

A key question is whether it is politically possible to modify senior preferences in ways suggested in this report. Policymakers are aware that older Americans vote in disproportionate numbers, and that they are vocal in making their needs known. Nevertheless, it will become increasingly difficult for states to meet those needs if some of the preferences described here are not modified before the bulge of the baby boomers becomes qualified to take advantage of them. The following are some suggestions of ways to improve the political chances of enacting the needed changes.

- Include the changes in senior preferences in a larger tax reform package that may include other changes that seniors view favorably. Such offsetting changes might include taking the sales tax off food and/or pharmaceuticals or enacting an income-targeted credit to offset the sales tax on those items, or increasing another tax to fund specific services important to seniors. In addition, if the tax preferences for some other groups are also being changed, seniors may feel less singled out. The recent change in senior tax preferences in Virginia was made in the context of a larger tax reform.

- It may be possible to sit down with organizations representing seniors in the state and discuss their priorities. They may have priorities they consider more important than preferences for higher-income seniors, and may be open to using the revenue from curtailing the preferences or other revenue to fulfill those priorities.

- When proposing a change from a non-targeted preference to a targeted preference for seniors, it may be possible to set the income ceiling for the preference at a level that will encompass between a third and a half of all seniors in the state. This could help deflect opposition.

- It might be possible to make the preference more generous than it currently is for the lowest-income seniors, while eliminating it for seniors at higher incomes. This could garner support for the change.

- Many people at age 65 today do not consider themselves "old," and few are poor. Poverty is higher at age 75 and higher still at age 85. It may be possible to re-target the senior preferences on an older cohort, rather than using age 65 as the qualifying age. Perhaps in combination with some of the other strategies above, this could improve the chances of support for the change.

- Retaining the tax preference for those already receiving it — grandfathering — could make the changes more acceptable because no one would lose a benefit that they are already receiving. In addition, phasing in the change rather than eliminating a benefit all at once could make it more palatable.

Background

The last four decades saw a significant improvement in the financial well-being of senior citizens. The next three decades will bring substantial growth in the senior population.

The population of the United States is aging as a result of medical advances that have increased life expectancy as well as because of the movement of the baby boomers through middle age. Nationally, the proportion of the population that is age 65 and older is projected to grow from 12.4 percent in 2000 to 19.7 percent by 2030. In 2005, residents age 65 and over made up more than 17 percent of the total population in only one state (Florida); by 2030, 45 states plus DC will be in this category. (See Table 1 and Figure 2.)

TABLE 1: PERCENT OF POPULATION 65 AND OLDER: 2005 AND 2030

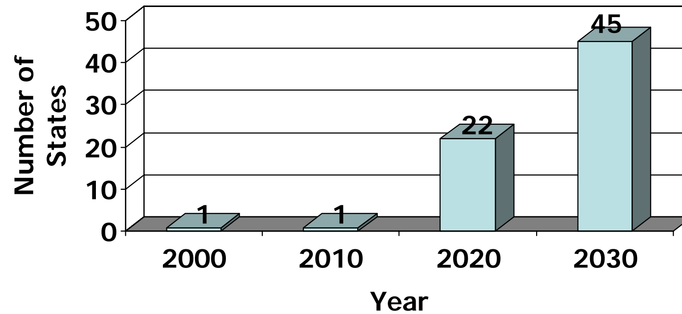
	2005 Percent of Population 65 and Older	2030 Percent of Population 65 and Older
Alabama	13.3%	21.3
Alaska	6.7%	14.7
Arizona	13.0%	22.1
Arkansas	13.8%	20.3
California	10.8%	17.8
Colorado	9.9%	16.5
Connecticut	13.7%	21.5
Delaware	13.2%	23.5
District of Columbia	11.6%	13.4
Florida	17.2%	27.1
Georgia	9.6%	15.9
Hawaii	13.3%	22.3
Idaho	11.3%	18.3
Illinois	12.0%	18.0
Indiana	12.3%	18.1
Iowa	14.7%	22.4
Kansas	13.0%	20.2
Kentucky	12.5%	19.8
Louisiana	11.9%	19.7
Maine	14.6%	26.5
Maryland	11.5%	17.6
Massachusetts	13.2%	20.9
Michigan	12.2%	19.5
Minnesota	11.9%	18.9
Mississippi	12.2%	20.5
Missouri	13.4%	20.2
Montana	13.9%	25.8
Nebraska	13.4%	20.6
Nevada	11.3%	18.6
New Hampshire	12.0%	21.4
New Jersey	13.1%	20.0
New Mexico	12.6%	26.4
New York	13.0%	20.1
North Carolina	11.9%	17.8
North Dakota	14.7%	25.1
Ohio	13.3%	20.4
Oklahoma	13.2%	19.4
Oregon	12.5%	18.2
Pennsylvania	15.3%	22.6
Rhode Island	13.9%	21.4
South Carolina	12.5%	22.0
South Dakota	14.2%	23.1
Tennessee	12.5%	19.2
Texas	10.0%	15.6
Utah	8.6%	13.2
Vermont	13.0%	24.4
Virginia	11.5%	18.8
Washington	11.3%	18.1
West Virginia	15.4%	24.8
Wisconsin	13.0%	21.3
Wyoming	12.5%	26.5
United States	**12.4%**	**19.7**

Source: U.S. Census Bureau, Population Division, Interim State Population Projections, 2005.
Internet Release Date: April 21, 2005

FIGURE 2

An Aging Population Will Increase Costs of Senior Tax Breaks

States where seniors are more than 17 percent of population



Source: Census Bureau projections

In the 1960s and 1970s when many states adopted tax preferences for seniors, elder poverty was a considerably larger problem than it is today. In 1970, one out of four Americans over the age of 65 had below-poverty incomes. Currently, less than ten percent of elderly Americans are poor. Because age is no longer so strongly correlated with poverty, it is more important to target tax relief by income.

It also makes sense to consider targeting senior tax preferences by age. Within the 65 and older age group, poverty increases with age. Some 9.4 percent of Americans aged 65 to 74 are poor while the poverty rate for the oldest residents — those over 85 — is 12.6 percent. Older Americans are healthier and more active than in the past and 65 is not as old as it may have seemed in the past.

Existing Senior Tax Preferences

States provide tax reductions for seniors through full or partial exemption of social security income and pension income from the income tax; added income tax exemptions, standard deductions or credits based on age; and age-based property tax reduction programs.

Social Security Income – Social security payments receive some form of special treatment in every state with a personal income tax. Some 28 states fully exempt social security payments from their income tax regardless of the income of the taxpayer. (See Table 2.)

TABLE 2: TREATMENT OF SOCIAL SECURITY INCOME	
	Exemption
Alabama	Full
Alaska	NA
Arizona	Full
Arkansas	Full
California	Full
Colorado	Partial (see note)
Connecticut	Full if income below $50,000/$60,000
Delaware	Full
District of Columbia	Full
Florida	NA
Georgia	Full
Hawaii	Full
Idaho	Full
Illinois	Full
Indiana	Full
Iowa	Partial (Same as federal except that only 50% is taxable at all income levels)
Kansas	Same as federal
Kentucky	Full
Louisiana	Full
Maine	Full
Maryland	Full
Massachusetts	Full
Michigan	Full
Minnesota	Partial (Same as federal)
Mississippi	Full
Missouri	Partial (Same as federal)
Montana	Partial (Same as federal)
Nebraska	Partial (Same as federal)
Nevada	NA
New Hampshire	NA
New Jersey	Full
New Mexico	Partial (Same as federal)
New York	Full
North Carolina	Full
North Dakota	Partial (Same as federal)
Ohio	Full
Oklahoma	Full
Oregon	Full
Pennsylvania	Full
Rhode Island	Partial (Same as federal)
South Carolina	Full
South Dakota	NA
Tennessee	NA
Texas	NA
Utah	Partial (Same as federal)
Vermont	Partial (Same as federal)
Virginia	Full
Washington	NA
West Virginia	Partial (Same as federal)
Wisconsin	Partial (Same as federal except that only 50% is taxable at all income levels)
Wyoming	NA

Source: David Baer, "*State Handbook of Economic, Demographic & Fiscal Indicators,*" AARP Public Policy Institute, 2003. Updated 2005 by CBPP.

Notes: Colorado: Pension exemption applies to all pensions combined including social security. Wisconsin: Will be full starting in 2008.

This special treatment of social security income has a long history. Until the mid 1980s, social security payments were exempt from both federal and state income taxes. As part of a major initiative to restore the finances of the social security system, the federal government began to tax a portion of the social security benefits of recipients above a specified income level. This change also reflected the improved economic status of many senior citizens. Under current federal law, social security payments are fully exempt from federal income tax only for single taxpayers with incomes below $25,000 and for married taxpayers with incomes below $32,000. (For this purpose, "provisional" income is used which consists of adjusted gross income plus one-half of social security benefits plus some additional income.)[2] A portion of the social security benefits of taxpayers with higher incomes are subject to federal income tax depending on how much other income the taxpayer receives. The federal government taxes 50 percent of the social security benefits of individuals with incomes between $25,000 and $34,000 and couples with incomes between $32,000 and $44,000. It taxes 85 percent of the benefits for individuals with incomes over $34,000 and couples with incomes over $44,000.

Most states failed to change their treatment of Social Security income when the federal government did so, and maintained their full exemption. Only twelve states – Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, and West Virginia – follow the federal provisions for determining whether to tax social security income. A thirteenth state, Connecticut, fully exempts social security income only for taxpayers with income under $50,000 (single) or $60,000 (married). The other states with income taxes fully exempt Social Security income. (Wisconsin which currently follows the federal provisions will fully exempt social security beginning in 2008.)

Pension Income – As people near and pass retirement age, their income sources change significantly. For those aged 55 to 65 wages and salaries make up three-fourths of their income. For those aged 65 and above wage and salary income declines to 25 percent and Social Security and pensions make up three-fifths of their income.

There are two major types of employment-based pension plans – defined benefit plans and defined contribution plans.

Under defined benefit plans, employers promise a specific regular payment to the employee in retirement. The employer contributes the amount necessary over the work life of the employee to pay the benefits after retirement. These contributions are tax deductible for the employer at the time they are made. For federal tax purposes, the pension payments employees receive in retirement are taxable.

Under defined contribution plans, the employee has access to a savings account that is funded through employee contributions and in some cases also through contributions by an employer. The contributions to the plans are made with pre-tax dollars; neither the employee nor the employer pays tax on the funds contributed. The income earned by the plan also is not taxable while it remains in the plan. Withdrawals from defined contributions are fully taxable for federal tax purposes. Traditional IRA's that allow tax-free deposits operate in the same manner as defined-contribution

[2] Provisional income consists of federal adjusted gross income plus one-half of social security benefits, tax-exempt interest and certain foreign-source income.

pension plans, as do various plans for self employed individuals.[3] These types of plans are called tax-deferred, because the tax on the contributions and earnings is not payable until they are withdrawn. The tax deferral provides a benefit because the employee can accumulate more funds in the account than if the contributions and earnings were taxed annually. In addition, most people have lower income after retirement than they did while they were working and may be in a lower federal tax bracket at the time they withdraw the funds and thus pay less tax on the funds when they are withdrawn.

The federal tax treatment of pension contributions provides a significant benefit to taxpayers and is intended as an incentive to encourage retirement savings. It makes little sense for states to provide still more generous treatment of retirement income, on top of the federal benefits, but a number of states do so. In a number of states, some or all of pension income is never taxed; it is tax exempt when deposited *and* tax exempt when it is withdrawn.

All except ten states with an income tax exempt some or all public pension income from their tax.[4] Some argument could be made in favor of exempting some public pension income, since it is the state or localities themselves that pay the pension. But a number of states extend the preferential treatment to private pensions.

Four states — Illinois, Mississippi, Pennsylvania and Tennessee exclude *all private and public* pension income from taxable income. Other states only partially tax private pensions. (See Table 3.) In states with partial exemptions, the amount exempted varies widely but is substantial. Sixteen states — Arkansas, Colorado, Delaware, Georgia, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Missouri, New Jersey, New York, Oklahoma, South Carolina, and Utah — exempt more than $5,000 of public and/or private pension income. In most states these exemptions are available to taxpayers without regard to ability to pay. Only five states – Missouri, Montana, Oklahoma, Oregon and Utah – limit these exemptions to taxpayers with income below specified levels.

Other Income Tax Preferences – Another common form of special tax treatment for seniors is the provision of additional personal exemptions or a higher standard deduction based on age. Of the states with an income tax, only five do *not* offer an expanded exemption or credit based on age. (See Table 4.) The most common forms are an additional personal exemption or credit or a higher standard deduction for those taxpayers over 65 years old. The amounts of the added exemptions average approximately $1,200 for one taxpayer and $2,500 for two taxpayers. These are not generally limited to low-income taxpayers. Most of the states that offer higher standard deductions for those over 65 use the federal definition of taxable income that includes a standard deduction that is $1,200 higher for one taxpayer over 65 and $1,900 for joint returns. Because the standard deduction does not benefit those who itemize their deductions — generally higher-income taxpayers — the higher standard deduction is more targeted to lower and middle income taxpayers than the additional personal exemptions. Other states offer credits ranging in size from $15 to $220 to seniors. Some states also offer credits that equal a portion of the federal elderly tax credit, which is means tested.[5]

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[3] There also are Roth IRAs and Roth defined contribution plans in which after tax dollars are deposited. The withdrawals from those accounts, including withdrawals of earnings on those accounts, are not taxed.

[4] These counts do not include states that exempt only military pensions.

[5] The federal elderly credit is up to $5,000 for single filers and up to $7,500 for joint filers. It is available to low-income taxpayers who receive little or no income from social security.

TABLE 3: INCOME TAX TREATMENT OF PENSION INCOME		
	Private Pension Exemption	**Public Pension Exemption**
Alabama	Full (Defined Benefit only)	Full (Defined Benefit only for state and local)
Alaska	N/A	N/A
Arizona	None	$2,500
Arkansas	$6,000	$6,000
California	None	None
Colorado[a]	$24,000/48,000 combined (65+) or $20,000/$40,000 (55-64)	
Connecticut[b]	None	None
Delaware	$12,500 (60+) or $2,000 (under 60) combined	
District of Columbia	None	$3,000 (62+)
Florida	N/A	N/A
Georgia	$15,000/$30,000 exemption on all retirement income	
Hawaii	Portion from employer contributions only	Full
Idaho	None	$21,900/32,850 minus Social Security (65+)
Illinois	Full	Full
Indiana	None	$2,000/$4,000 minus Social Security for federal retirees (62+), or $2,000 for military retirees (60+)
Iowa	$6,000/$12,000 combined (55+)	
Kansas	None	Full
Kentucky	$40,200	$40,200 (Full for taxpayers retiring before 1998)
Louisiana	$6,000 (65+)	Full
Maine	$6,000 minus Social Security	$6,000 minus Social Security ($6,000 for military pensions)
Maryland	$20,700 minus Social Security (65+)	$20,700/$41,400 minus Social Security (65+)
Massachusetts	None	Full
Michigan	$38,550/ $77,100	Full
Minnesota	None	None
Mississippi	Full	Full
Missouri	$6,000/$12,000 (phased out between $25,000/$32,000 and $31,000/$44,000)	$6,000/$12,000 (phased out between $25,000/$32,000 and $31,000/$44,000)
Montana	Up to $3,600/$7,200 (depending on income, phased out above $31,800/ $33,600)	Up to $3,600/$7,200 (depending on income, phased out above $31,800/ $33,600)
Nebraska	None	None
Nevada	N/A	N/A
New Hampshire	Full	Full
New Jersey	$15,000/$20,000 (62+)	$15,000/$20,000 (62+)
New Mexico	None	None
New York	$20,000 (59.5+)	Full
North Carolina	$2,000/$4,000	$4,000/$8,000 (Full if worked five years before 8/89)
North Dakota	None	$5,000 minus Social Security
Ohio	Tax credit of up to $200	Tax credit of up to $200
Oklahoma (*)	$5,500/$11,000 (65+) if income under $25,000/$50,000	$5,500/$11,000
Oregon	Tax credit of up to 9 percent (62+) and income under $22,500/$45,000 and under $7,500/$15,000 in Social Security)	Tax credit of up to 9 percent (62+) and income under $22,500/$45,000 and under $7,500/$15,000 in Social Security)
Pennsylvania	Full	Full
Rhode Island	None	None
South Carolina	$10,000/$20,000 (65+) / $3,000/$6,000 (under 65) any pension public or private	
South Dakota	N/A	N/A
Tennessee	Full	Full
Texas	N/A	N/A
Utah	$4,800/$9,600 (under 65) $7,500/$15,000 (65+) phases out between $25,000/$32,000	$4,800/$9,600 (under 65) $7,500/$15,000 (65+) phases out between $25,000/$32,000
Vermont	None	None
Virginia	None	None
Washington	N/A	N/A
West Virginia	None	$2,000; full for police and fire; $20,000 military retirees
Wisconsin	None	Military pensions plus retirees before 1964 from federal government, Milwaukee, or teaching
Wyoming	N/A	N/A

Notes: Where there are 2 income numbers, the first is for single taxpayer/the second is for joint filers. (a) Colorado: Only social security income included in federal AGI is included in calculation to determine in any social security or pension income is taxable. (b) Connecticut: For taxpayers with income above the cut-offs, up to 25% of social security income is subject to tax. (c) Oklahoma: Pension exemption was increased in 2005 to greater of 50% or $10,000 for retirees with income under $37,500/$75,000.

Source: David Baer, "State Handbook of Economic, Demographic & Fiscal Indicators," AARP Public Policy Institute, 2003.
Updated by CBPP to 2004 provisions.

TABLE 4: OTHER INCOME TAX PREFERENCES

	Added Exemption	Higher Standard Deduction [65+]	Other
Alabama			
Alaska	NA	NA	NA
Arizona	$2,100/$4,200		
Arkansas			$20/$40 credit
California			Credit of $85/$170 (65+)
Colorado		$1,200/$1,900	
Connecticut			
Delaware		$2,500/$5,000	Personal credit (60+) $110/$220
District of Columbia	$1,370/$2,740		
Florida	NA	NA	NA
Georgia		$1,300/$2,600	
Hawaii	$1,040/$2,080		
Idaho		$1,200/$1,900	Additional $15 grocery credit per person 65+
Illinois	$1,000/$2,000		
Indiana	$1,500/$3,000 if income is under $40,000; $1,000/$2,000 if income is more than $40,000		Credit of up to $100/ $140 (65+, income under $10,000)
Iowa			Credit of $20/$40 (65+)
Kansas		$850/$1,400	
Kentucky			Credit of $20/$40 (65+)
Louisiana	$1,000/$2,000		
Maine		$1,200/$1,900	
Maryland	$1,000/$2,000		
Massachusetts	$700/$1,400		
Michigan	$2,000/$4,000		Exemption of $8,595/$17,190 in interest, dividends, and capital gains; can also deduct amount of federal elderly tax credit
Minnesota		$1,200/$1,900	Exemption of $9,600/$12,000 of any income minus Social Security (phases out between $14,500/18,000 and $33,700/$42,000)
Mississippi	$1,500/$3,000		
Missouri		$1,200/$1,900	
Montana	$1,840/$3,680		
Nebraska		$1,180/$1,960	
Nevada	NA	NA	NA
New Hampshire	$1,200		
New Jersey	$1,000/$2,000		Exemption of $15,000/$17,500 covers all income if earned income is under $3,000/$6,000 or not covered by Social Security (62+)
New Mexico		$1,200/$1,900	Exemption of $8,000 of any income (65+) and income is under $28,500/$51,000
New York			
North Carolina		$750/$1,200	
North Dakota		$1,200/$1,900	
Ohio			Credit of $50 (65+)
Oklahoma	$1,000/$2,000		
Oregon		$1,200/$2,000	
Pennsylvania			
Rhode Island		$1,190/$1,890	
South Carolina		$1,200/$1,900	Exemption of $15,000/$30,000 less retirement income
South Dakota	NA	NA	NA
Tennessee			Exemption of $16,200/$27,000 (65+)
Texas	NA	NA	NA
Utah		$1,200/$1,900	
Vermont		$1,200/$1,900	
Virginia	$800/$1,600		Exemption of $6,000 (62-64) or $12,000 (65+) from any income source
Washington	NA	NA	NA
West Virginia			Exemption of $8,000/$16,000 (65+) from any income source
Wisconsin	$250		
Wyoming	NA	NA	NA

Source: David Baer, "State Handbook of Economic, Demographic & Fiscal Indicators," AARP Public Policy Institute, 2003. Updated by CBPP to 2004 provisions.

In addition, a few states offer substantial exemptions of certain types of income to seniors. For example, Michigan exempts $8,595 (for single filers) and $17,190 (for joint filers) in interest, dividends and capital gains income received by seniors. Virginia exempts $12,000 of income from any source for taxpayers who are 65 years and older. Virginia's exemption phases out above a specified income level. Similarly, West Virginia exempts up to $8,000 in income for taxpayers who are 65 years and older without any income limit on who can use the exemption.

Property Tax Preferences – Property tax reductions for seniors often take the form of homestead exemptions or credits that reduce the amount of property taxes owed. While the property tax is primarily a local tax, homestead exemptions can have a significant impact on state budgets. In some cases, states provide aid payments to local governments to compensate for the costs of the property tax exemptions. Even in states without specific property tax replacement aid programs, the erosion of the local property tax base puts pressure on state governments to fill in the gap and assist localities in funding schools and other important local services.

All but ten states offer some form of homestead exemption or credit program. (See Table 5.) Of these, 26 offer programs targeted specifically to seniors. Of the 26, half have senior-only programs while the other half offer additional more generous homestead exemptions or credits to seniors. Some of these programs are limited to taxpayers with incomes below a specific level but more often they are open to all taxpayers regardless of income.

An alternative way of providing help with property taxes that is more targeted to those in need is to offer a property tax circuit-breaker credit. These are discussed in more detail in the box on page 13 and in the section titled Alternatives later in this report.

Trends Over Time

Since the late 1970s the number and type of senior tax preferences offered by states have changed. A recent paper by Karen Conway, professor of economics at the University of New Hampshire, and Jonathan Rork, professor of economics at Vassar College, found that there is a trend towards reduced preferences at the federal level but not at the state level on average.

Conway determines the amount that the effective income tax rate for seniors is below the rate for the non-elderly for both federal and state taxes. The effective rate is the amount of taxes paid as a percentage of total income. At the federal level, this tax advantage for seniors has been declining over the past few decades for two main reasons. In the 1980s, the federal government began to tax a portion of social security benefits for taxpayers with incomes above a certain level. In addition, the value of the higher standard deduction for seniors has remained relatively constant while the exemptions and standard deduction available to all taxpayers were expanded in the 1980s. This reduced the relative value of the senior exemptions. Moreover, unlike the states, the federal government has not moved to exempt pension income from the income tax base.

The trends at the state level are more mixed. As noted, only 14 states have followed the federal government's lead and begun to tax some Social Security benefits; the others maintained their full exemptions. Many states adopted or expanded exemptions for public and private pensions, which increased the tax advantage for seniors at the state level. Conway found that while a number of

TABLE 5: STATE HOMESTEAD EXEMPTION AND CREDIT PROGRAMS

	All		Elderly	
	Flat Amt.	% of value	Flat Amt.	% of value
Alabama	X		X	
Alaska	X		X	
Arizona	X			
Arkansas	X			
California	X			
Colorado				X
Connecticut			X	
Delaware				X
District of Columbia	X			X
Florida	X		X	
Georgia	X		X	
Hawaii	X		X	
Idaho		X		
Illinois	X		X	
Indiana	X			
Iowa	X			
Kansas	X			
Kentucky			X	
Louisiana	X			
Maine	X			
Maryland				
Massachusetts			X	
Michigan				
Minnesota	X			
Mississippi	X		X	
Missouri				
Montana				
Nebraska			X	
Nevada				
New Hampshire			X	
New Jersey	X		X	
New Mexico	X			
New York	X		X	
North Carolina				X
North Dakota			X	
Ohio		X	X	
Oklahoma	X			
Oregon				
Pennsylvania	X			
Rhode Island				
South Carolina	X		X	
South Dakota				
Tennessee	X		X	
Texas	X			
Utah				X
Vermont				
Virginia			X	
Washington			X	
West Virginia			X	
Wisconsin	X			
Wyoming				
Count	26	2	21	5

Source: State Programs and Practices for Reducing Residential Property Taxes, David Baer, AARP May 2003.

Notes: Excludes programs available only to veterans and disabled. Texas: Both are a local option.

Types of Property Tax Credits and Exemptions

The two most common types of property tax reduction programs that are often targeted to senior taxpayers are homestead exemptions or credits and circuit breaker type credits. These are described below.

The property tax calculation — in order to understand property tax reduction methods it is useful to review the property tax calculation. For the purposes of this example, we will assume the taxpayer owns a home with an assessed value of $150,000 and a property tax rate of 2% (that is, 20 mills or $20.00 per one thousand dollars of value.) The amount of tax owed equals the property tax rate times the assessed value.

With no exemptions or credits the property tax owed on this property would equal $3,000:

.02 (rate) X $150,000 (value) = $3,000 (tax)

Homestead Exemptions or Credits – Homestead exemptions reduce property taxes by exempting a specific amount of a house's value from the property tax calculation. The amount can either be a flat dollar amount or a percentage of the assessed value of the home. Using the example above, a homestead exemption equal to $20,000 would reduce taxes owed by $400 to $2,600.

.02 (rate) X [$150,000 (value) - $20,000 (exemption)] =

.02 (rate) X [$130,000 (value after exemption)] = $2,600

A homestead exemption that is equal to a percentage of the value would operate similarly except that the amount of the exemption would vary depending on the value of the home. For example, a 10% homestead exemption would equal $15,000 in value in the example above. This would reduce the taxable value of the house to $125,000 ($150,000 minus $15,000). Taxes would, thus, be reduced by $300 to $2,700.

Some states offer homestead credits rather than exemptions. A homestead credit is a reduction in taxes owed as opposed to a reduction in the taxable value. A $400 homestead credit would reduce the taxes owed on the house in the example to $2,600 ($3,000 minus the $400 credit).

Property Tax Circuit Breaker Credit – Property tax circuit-breakers are designed to prevent low-income and elderly taxpayers from being "overloaded" by their property tax bill. Typically, the state establishes a maximum percentage of income that a family that qualifies for the circuit-breaker can be expected to pay in property taxes; if this limit is exceeded, the state provides a credit against taxes owed or a rebate to the taxpayer.

For example, a circuit breaker may limit property taxes owed to no more than 3.5 percent of income. If the owner of the home in the example above had an income of $50,000, the $3,000 in property taxes owed would equal 6 percent of income. The taxpayer would receive a credit or rebate equal to the amount needed to bring this percentage down to 3.5 percent. In this example that would equal $1,250.

$3,000 (tax owed) minus [$50,000 (income) X .035 (maximum share of income allowed)]

$3,000 minus $1,750 = $1,250

(Most state circuit breaker programs are available only to taxpayers with income below a specified level and include a maximum allowable payment.)

states greatly expanded elder tax preferences over this period, there were some states that reduced them. (Conway's paper shows the trend in each state.) On average, state tax preferences for the elderly have remained fairly constant over the last two decades while federal preferences have been declining.

Another set of researchers, Sally Wallace, professor of economics at the University of Georgia and Barbara Edwards of the Congressional Budget Office, attempted to quantify the relative level of senior preferences by state in a 2004 paper. Table 6 and Figure 3 show the results of their analysis of the differences in effective state income tax rates for the elderly versus the non-elderly for each state. The states with the highest differentials – that is the largest senior bonus – are Michigan, Kentucky, Georgia, South Carolina, Hawaii, Indiana, Idaho, Oregon, Wisconsin, Arkansas, Connecticut, Illinois and Pennsylvania.[6]

Are Existing Senior Preferences Reaching Their Intended Targets?

The main arguments advanced for tax preferences for seniors are income-related. Supporters of these tax breaks argue that they are needed because seniors must live on fixed incomes while their costs, especially for health care and housing, continue to growth. Many senior tax preferences were enacted decades ago when the senior poverty level was much higher. In addition, in the past, it was much more common for taxpayers with below-poverty incomes at any age to be subject to state income taxes.

Because being a senior citizen is no longer synonymous with being poor and many states have adopted tax relief for low-income taxpayers of all ages, a significant share of the dollars states spend on senior tax preferences is being directed to high-income taxpayers with the means to pay taxes.

For example, added exemptions for seniors benefit taxpayers regardless of their income. The value of an added exemption depends on the tax rate that the taxpayer pays on each additional dollar of income. In states with graduated rate structures — ones where the tax rate increases as income increases — added exemptions provided a greater benefit to higher income taxpayers because their marginal tax rates are higher. Thus, the added exemption reduces taxes for high-income taxpayers who have the means to pay taxes. In addition, many states have adopted measures that exempt their lowest-income taxpayers from the income tax so they do not benefit at all from increased exemptions.

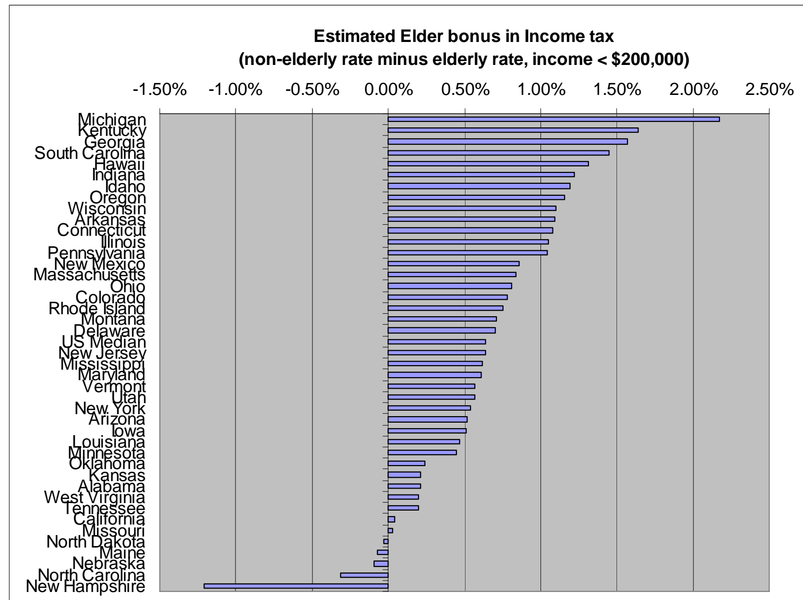
It is important to note that providing a higher standard deduction rather than a higher personal exemption eliminates some of this problem because most high income taxpayers itemize their deductions and, thus, do not benefit from an increase in the standard deduction. (Only 9 percent of taxpayers with incomes over $100,000 used the standard deduction according to IRS data from 2003.)

[6] At the time the Wallace-Edwards study was prepared Virginia had one of the highest differentials, but has since scaled back its senior preferences. Thus we have not included them in this list.

TABLE 6: EFFECTIVE RATE OF INCOME TAX FOR THE ELDERLY	
	Difference in effective income tax rate for elderly vs others (income <$200K) (elderly rate minus others)
Alabama	-0.21%
Alaska	No Income Tax
Arizona	-0.52%
Arkansas	-1.09%
California	-0.04%
Colorado	-0.78%
Connecticut	-1.08%
Delaware	-0.70%
District of Columbia	NA
Florida	No Income Tax
Georgia	-1.57%
Hawaii	-1.31%
Idaho	-1.19%
Illinois	-1.05%
Indiana	-1.22%
Iowa	-0.51%
Kansas	-0.21%
Kentucky	-1.64%
Louisiana	-0.47%
Maine	0.07%
Maryland	-0.61%
Massachusetts	-0.84%
Michigan	-2.17%
Minnesota	-0.45%
Mississippi	-0.62%
Missouri	-0.03%
Montana	-0.71%
Nebraska	0.09%
Nevada	No Income Tax
New Hampshire	1.21%
New Jersey	-0.64%
New Mexico	-0.86%
New York	-0.54%
North Carolina	0.31%
North Dakota	0.03%
Ohio	-0.81%
Oklahoma	-0.24%
Oregon	-1.16%
Pennsylvania	-1.04%
Rhode Island	-0.75%
South Carolina	-1.45%
South Dakota	No Income Tax
Tennessee	-0.20%
Texas	No Income Tax
Utah	-0.57%
Vermont	-0.57%
Virginia	-1.70%
Washington	No Income Tax
West Virginia	-0.20%
Wisconsin	-1.10%
Wyoming	No Income Tax
US Median	-0.64%

Source: Wallace, Edwards, How Much Preference: Effective Personal Income Tax Rates for the Elderly, April 2002.

FIGURE 3



Source: Barbara Edwards and Sally Wallace, *How Much Preference: Effective Personal Income Tax Rates for the Elderly*, April 2002

The impact of pension exemptions also varies by income. The amount of retirement income received — Social Security and private and government pensions — increases as total family income increases, so the dollar value of the tax reduction provided by full pension exclusions is higher for higher income families. In addition, the fact that many states exempt low-income taxpayers from the income tax means that those most in need do not receive any benefit from these provisions. For example, Colorado exempts married couples with no children from its income tax if their income is below 121 percent of poverty; as a result, no elderly couples with below poverty income benefit from the state's generous pension exemption. The same high-income seniors who receive the largest dollar benefit from pension exemptions depend the least on pensions and social security for their income. According to the consumer expenditure survey, pensions and social security make up only 32 percent of income for the elderly with incomes of $70,000 and above compared to approximately 90 percent for those with incomes below $20,000.

The design of social security exemptions determines who benefits from these provisions. Most states fully exempt social security payments but a dozen states follow the practice of the federal government and only exempt social security income for those below a specified income level. The retirees who are subject to the federal tax are often people of substantial means who have built up assets over time.

TABLE 7: ESTIMATED POTENTIAL REVENUE LOSS IN MINNESOTA AS A PERCENT OF INCOME TAX REVENUE		
	2002	**2030**
Fully exempt social security benefits	-2.3%	- 5.0%
Exempt all pension payments	-6.4%	-12.6%
Exempt both social security and pension income	-8.1%	-15.8%

Source: State Income Tax Revenue in 2002 and 2003: *The Impact of the Retirement of the Baby Boom*, State Tax Notes, January 23, 2006.

How Much Do These Preferences Cost the States?

Little information has been collected on the costs of these preferences to the states. A recent report prepared by researchers with the Minnesota House of Representatives and Department of Revenue sheds some light on the amount of revenue lost as a result of these preferences. Using the current Minnesota tax system as a base, these researchers estimated the amount that typical types of preferences would cost if Minnesota adopted them. Currently, Minnesota follows the federal treatment of Social Security benefits and does not exempt pension income. The Minnesota study found that the costs of these exemptions are significant and will grow substantially in the future. The analysis showed that fully exempting social security benefits would have reduced state income tax revenue by 2.3 percent ($107 million) in 2002. This cost would more than double to 5.0 percent by 2030. The cost of fully exempting pensions or of exempting both pensions and all social security benefits follows a similar pattern. If Minnesota had fully exempted social security and pension income in 2002 income tax revenue would have been reduced by 8.1 percent. The cost is projected to double by 2030. (See Table 7.) The Minnesota analysis gives some information about the potential cost of the types of preferences are incurring, but the results are not directly transferable to other states because they are determined in part by the make-up of Minnesota's population and its income tax structure.

In order to get more information on the costs to individual states, the Center reviewed tax expenditure budgets in selected states to determine how much revenue is being forgone as a result of senior tax preferences. Table 8 contains the data we were able to locate in those states that publish tax expenditure budgets.

- The cost of senior tax preferences in a state such as Kentucky that fully exempts social security income from taxation, and offers pension exemptions as well as added personal exemptions based on age currently equally approximately 4.3 percent of the state's general fund.

- In contrast, the cost of senior preferences in a state that offers few preferences or targets them by income such as Louisiana or Connecticut is relatively small – 0.5 percent or less of the general fund.

- In a state with a moderate level of preferences, such as Delaware or Missouri, the cost is currently about 2.0 percent of the general fund.

TABLE 8: EXAMPLES OF COSTS OF INCOME TAX PREFERENCES									
	Pension/Retirement income preferences	Annual cost (millions)	Social Security Income preferences	Annual cost (millions) (1)	Other preferences	Annual cost (millions)	Total of available estimates	Year of estimate	Percent of General Fund Revenues
California			Full exemption of SS income	$655.0	Additional exemption	$97.0	$752.0	2004	1.0%
Connecticut			Full exemption of SS income (income below $50,000/$60,000	$35.0			$35.0	2004	0.3%
Delaware	Pension and Retirement income (partial)	$31.5	Full exemption of SS income	$16.0	Additional personal credit ($110)	$5.5	$53.0	2004	1.9%
Idaho	Pension and Retirement income (public only)	$4.2	Full exemption of SS income	$25.7			$29.9	2004	1.4%
Illinois	Pension and retirement income (cost included with SS income est.)		Full exemption of SS income & full exemption of pension income	$757.7	Additional exemption	$31.2	$788.9	2004	3.4%
Iowa	Pension, private & govt (partial)	$75.0	Up to half exempt	$25.0	Additional credit	$2.9	$102.9	2004	2.2%
Kentucky (1)	Pension, private & govt (partial)	$235.1	Full exemption of SS income (1)	$71.6			$306.7	2004	4.3%
Louisiana	Pension and Retirement income (partial)	$12.6					$12.6	2004	0.2%
Massachusetts (1)			Full exemption of SS income (1)	$127.3	Additional exemption ($700)	$20.3	$147.6	2004	0.6%
Michigan	Pension and Retirement income	$510.0	Full exemption of SS income	$140.0	Additional exemption	$38.2	$688.2	2004	3.7%
Minnesota					Subtraction of income of elderly or disabled	$1.2	$1.2	2004	0.0%
Mississippi	Pension and Retirement (cost included with SS income est.)		Full exemption of SS income and pension exemption	$203.3	Additional Exemption	na	$203.3	2005	5.2%
Missouri	Pension, private & govt partial	$153.7					$153.7	2004	2.2%
Montana	Pension, private & govt partial	$4.6			Additional exemption	$6.1	$10.7	2004	0.8%
New York	Pension, public (full) & private (partial)	$1,016.0	Full Exemption of SS income	$452.0			$1,468.0	2005	3.4%
North Carolina	Pension, private & govt partial	$314.8	Full exemption of SS income	$179.2	Higher standard deduction		$494.0	2004	3.4%
Ohio	Public Private pension credit (partial)	$87.9	Full exemption of SS income	$173.7	Additional credit	$20.3	$281.9	2004	1.2%
Oklahoma	Public Private pension credit (partial)	$38.7	Full exemption of SS income	$63.5	Additional exemption	$0.8	$103.0	2004	2.0%
Oregon	Pension, private & govt (partial)	$1.3	Full exemption of SS income	$106.6			$107.9	2004	2.2%
Pennsylvania (1)	Pension, private & govt	$978.1	Full exemption of SS income(1)	$140.1			$1,118.2	2004	5.1%
West Virginia	Public pensions (partial)	11.9			All income exclusion up to $8,000/$16,000	$34.7	$46.6	2004	1.5%
Wisconsin	Public pensions (limited)	$51.5	Up to half exempt	$40.0	Additional exemption	na	$91.5	2004	0.8%

Source: Various state tax expenditure reports. Percent of general fund spending is CBPP calculation using NASBO data.
(1) The cost of the social security exemption is the cost of exempting amounts that are taxed federally. For Kentucky, Massachusetts and Pennsylvania this cost was estimated using data on taxable social security benefits from the IRS and the states' tax rate.

TABLE 9: EXAMPLES OF COST OF SENIOR PREFERENCES CURRENTLY AND PROJECTED TO 2030				
	Total of available estimates		Cost in 2004 for number of seniors projected for 2030	
	Amount (millions)	Percent of General Fund	Amount (millions)	Percent of General Fund
California	752.0	1.0%	1,630.3	2.2%
Connecticut	35.0	0.3%	58.7	0.5%
Delaware	53.0	1.9%	115.7	4.2%
Idaho	29.9	1.4%	68.0	3.2%
Illinois	788.9	3.4%	1,251.4	5.4%
Iowa	102.9	2.2%	157.6	3.4%
Kentucky	306.7	4.3%	533.6	7.5%
Louisiana	12.6	0.2%	22.5	0.3%
Massachusetts	147.6	0.6%	252.8	1.1%
Michigan	688.2	3.7%	1,148.7	6.2%
Minnesota	1.2	0.0%	2.3	0.0%
Mississippi	203.3	5.2%	365.3	9.3%
Missouri	153.7	2.2%	261.3	3.8%
Montana	10.7	0.8%	22.8	1.6%
New York	1,468.0	3.4%	2,306.6	5.3%
North Carolina	494.0	3.4%	1,040.0	7.1%
Ohio	281.9	1.2%	435.7	1.8%
Oklahoma	103.0	2.0%	168.0	3.3%
Oregon	107.9	2.2%	206.9	4.2%
Pennsylvania	1,118.2	5.1%	1,704.0	7.8%
West Virginia	46.6	1.5%	71.4	2.3%
Wisconsin	91.5	0.8%	167.8	1.6%

Source: CBPP calculations of data from various state tax expenditure reports.
Census projections and NASBO

Methodology: First, cost per senior in 2004 was estimated. This was multiplied by projected number of seniors for 2030.
Result was divided by 2004 General Fund revenues to get percent of GF figure.

By combining this information with Census projections of the growth in the number of elderly by state, we were able to estimate the growth in the cost of these preferences.[7] Table 9 shows the current and projected costs for the states that had data available. These projections show that the cost will almost double in most states and will equal approximately four percent of the General Fund in a state with an average amount of preferences and 7 percent or more in a state with a large number of preferences. This represents a serious drain on state treasuries at a time when states will be facing pressures on the spending side of the budget from the aging of the population.

Alternatives

There are a number of ways that states can address this growing revenue loss while still providing assistance to those seniors in need. In general, this requires updating these programs in light of the fact that being elderly is no longer synonymous with being poor. This can be done by including

[7] In order to estimate the future cost of these preferences we used the following methodology. First, the cost per senior in 2004 was calculated using the tax expenditure data and Census data. We then multiplied that cost by the number of seniors projected by Census for the state and then compared that to 2004 General Fund Revenues. This results in an estimate of the cost in dollars and as a share of the General Fund of these preferences in 2004 if the number of seniors were equal to what is projected for 2030.

income limits or tests as a part of existing tax reduction programs for seniors, or making sure that these are part of any new senior tax preferences.

For example:

- More states could use the federal provisions for taxation of social security rather than completely exempting social security income from taxation. Currently 12 states follow federal policy for taxation of social security benefits – Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont, and West Virginia. Alternatively, states could limit the exemption of social security income to taxpayers below a certain income level, as Connecticut does.

- States that offer exemptions for public or private pensions could phase them out at a specific income level, only offer them to taxpayers with incomes below a certain level or establish a cap or lower an existing cap on the amount of pension exempted. For example, as a part of a large tax package adopted in 2004, Virginia scaled back its preferential treatment of pension income by phasing out the exemption for starting at $75,000 for joint filers and $50,000 for single filers.

- States could convert their age-based additional personal exemption to a higher standard deduction – such as the deduction from federal taxes – would target these preferences more to lower and middle income taxpayers. Only states that include standard deductions in their income tax could make this change.

- Additional states could offer property tax circuit breakers rather than homestead exemptions or credits. Under the provisions of a circuit-breaker, taxpayers receive a credit if their income is below a defined level and their property taxes exceed a specified percentage of their income. Currently, some 34 states offer property tax circuit breaker programs. The size of the benefit and eligibility for these programs vary widely and they often exist in addition to homestead exemption or credit programs that are not tied to income. States could expand circuit breaker programs and cut back on non-means tested property tax reduction programs in order to target tax relief to those most in need of it.

- State could raise the eligibility age for their age based credits and exemptions in order to target them to the seniors who have the least ability to pay. The percent of people 75 years old and older in poverty is higher than the percent of those between 65 and 75.