FISCAL IMPACT REPORT

SPONSOR Burt **ORIGINAL DATE** 1/30/2020 **LAST UPDATED** 2/7/2020 **HB**

SHORT TITLE Uniformed Svc Retiree Income Tax Deduction **SB** 169

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	FY21	FY22	FY23	FY24		
		($8,000.0)	($16,000.0)	($24,000.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY20	FY21	FY22	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
		$15.4	$15.4	Nonrecurring	TRD Operating

Parenthesis ( ) indicate expenditure decreases

HB249 is a duplicate.

SOURCES OF INFORMATION
LFC Files

Responses Received From
Veteran's Services Department (VSD)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 169 creates a personal income tax deduction for military retirees. The deduction is phased in as follows:

For Taxable Year	% of Military Pension Deductible	Deduction limit
2021	33%	$16,333
2022	66%	$33,666
2023 et seq	100%	$50,000

The purpose of the deduction is to encourage uniformed services retirees to make New Mexico the retirees' state of residency and to utilize the expertise of uniformed services retirees in New Mexico's workforce and business community.

TRD is required to compile an annual report of the number of taxpayers claiming this deduction and the costs to the general fund.

"Uniformed services" means army, navy, air force, marine corps. coast guard, army reserve, navy reserve, marine corps reserve, coast guard reserve, army national guard, air national guard, United State public health service commissioned corps as well as the commissioned officer corps of the national oceanic and atmospheric administration. Spouses of a uniformed services member who was killed in the line of duty is also eligible to claim this deduction.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends (May 20, 2020). The provisions of the bill are applicable to taxable years beginning on or after January 1, 2021.

FISCAL IMPLICATIONS

This bill may be counter to the LFC tax policy principle of adequacy, efficiency and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

TRD has analyzed this bill using tax returns actually filed, whereas the previous LFC estimate had been done using collateral sources. TRD explains its methodology as follows:

> Two sources of data were analyzed to arrive at an estimated revenue impact. The first data source is the Department of Defense (DOD), annual *Statistical Report on the Military Retirement System* for fiscal year ended September 20, 2018. The second data source was a sample of New Mexico military retiree state income tax returns for tax year 2018.
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> The *Statistical Report on the Military Retirement System* provides an aggregate number of retirees and survivor beneficiaries by state and an aggregate amount of benefits distributed. As of September 30, 2018, New Mexico had 21,053 reported retirees and 2,845 survivor beneficiaries. Aggregate annual distribution of military retirement benefits was approximately $594 million.
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> The sample of military retiree returns was used to establish an average personal income tax (PIT) decrease per retiree and survivor beneficiary based on the bill's step-wise percentage deductions of 33 percent in Tax Year 2021, 66 percent in Tax Year 2022 and 100 percent in Tax Year 2023 and beyond. Retiree annuities were increased through the three years by a cost of living adjustment which for most retirees per the DOD report is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W). All other taxable income reported on the returns was kept flat. Subtracting the calculated deduction amount, a new taxable income was calculated and the PIT rates applied to determine the new PIT

due. An average PIT decrease per each year was calculated with the sample of 15,000 returns.

It is assumed that the sample of approximately 15,000 military retiree returns is representative of the approximately 24,000 total reported retirees and survivors. The average PIT decrease per year was multiplied by the 24,000 retirees. It is assumed that the net immigration and emigration of military retirees into the state per year is zero. The estimate also assumes that net new retirees and deceased retirees per year is zero. Thus, the analysis assumes a constant 24,000 returns per year are eligible for the deduction. Finally, the analysis assumes 100 percent of qualifying retirees will claim the deduction in the first year of eligibility.

In 2009, the Arrowhead Center published a study entitled, "The Economic Impact of Exempting Retired Military Service Payments from New Mexico Personal Income Tax". Total number of military retirees was "nearly 20 thousand", although Table 1 of the study indicated that New Mexico had 21,274 military retirees and that represented 1.08 percent of the population. Fifteen states with exemptions for Military Retirement pay or with no income tax averaged about .6 percent of the population, with only Alabama exceeding New Mexico's ratio. The U.S. average was .66 percent of the population were military pensions. The Arrowhead Center report estimated the cost of a full exemption for military retirement would be about $8.5 million. Unfortunately, the study assumed that the pension income/exemption would be taxed at average income tax rates of less than 2 percent, where the analysis contained in this FIR assumed a 3 percent marginal rate on the income for the lower income retirees and 4 percent for the higher income retirees. This difference is critical, because an exemption, as proposed here, would be taxed at higher marginal rates than average income for the population generally. The study makes no attempt to address the issue of "buying the base", but makes the comment, "The historical growth rate for retiree military service pensions is, on average 1.5 percent. If this growth rate was doubled [as a direct result of this exemption], the state would experience a positive yearly contribution due to increase personnel in year six and experience overall net benefits in year ten…"

On the other hand, the current estimate of military service retirees is 21.4 thousand, with virtually no net growth from 2007/2009 from the Arrowhead study. This probably implies that the WWII and Korean era and some retirees who served in the Vietnam era are dying and new retirees are barely making up in numbers for the retirees who are dying.

The key question is whether the incentive here, which could be up to $2,500 per year per retiree would be sufficient to change retirement location decisions. See also "Alternatives" below for an alternative proposal that provides incentives but does not "buy the base".

SIGNIFICANT ISSUES

The stated purpose of this deduction is to provide incentives to encourage uniformed services retirees to make New Mexico the retirees' state of residency and to utilize the expertise of uniformed services retirees in New Mexico's workforce and business community. Available data indicates that this might not be necessary. One must assume that the majority of retirees will either return to their declared home state or will remain in the state of their last domestic posting. New Mexico is ranked 13th in the nation for the percentage of the population that are veterans. 9.6 percent of the state's civilian population are veterans. The national average is 7.9 percent.

On the other hand, military retirees generally retire relatively young and subsequently begin a second or even third career. Military retirees represent about 14 percent of New Mexico's veterans. Because of this, total median income of New Mexico's veterans was $37.1 thousand in

2014, compared to a median annual income of nonveterans of \$21.8 thousand. New Mexico ranks 48th in median income for nonveterans and 21st for veterans.

New Mexico is one of eight states that fully tax military pensions. Twenty states do not tax military pensions, but do have a personal income tax. Thirteen more states provide partial deductions or exemptions.

Appended to this report is a chart labeled, "Quick Facts about New Mexico's Veterans." These data were obtained from the 2015-2018 American Community Survey available from the U.S. Census.

TRD has submitted extensive analysis of the impact and equity of this proposal:

> PIT revenue represents a fairly consistent source of revenue for many states. PIT revenue is susceptible to economic downturns but also positively responsive to economic expansion. New Mexico is one of forty-two states along with the District of Columbia which impose a broad-based personal income tax. The personal income tax is seen as both horizontally equitable, the same statutes apply to all taxpayers and vertically equitable, due to the progressive design of the personal income tax. Progressive, in this context, meaning taxes where the average tax rate increase as the taxable amount increases.
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> Excluding types of retirement income from the taxable base is seen as eroding horizontal equity in state income taxes. By excluding income based on age or by profession, taxpayers in similar economic circumstances are no longer treated equally. Income exemptions based on age violate horizontal equity by benefiting taxpayers on the basis of age instead of the amount of income.
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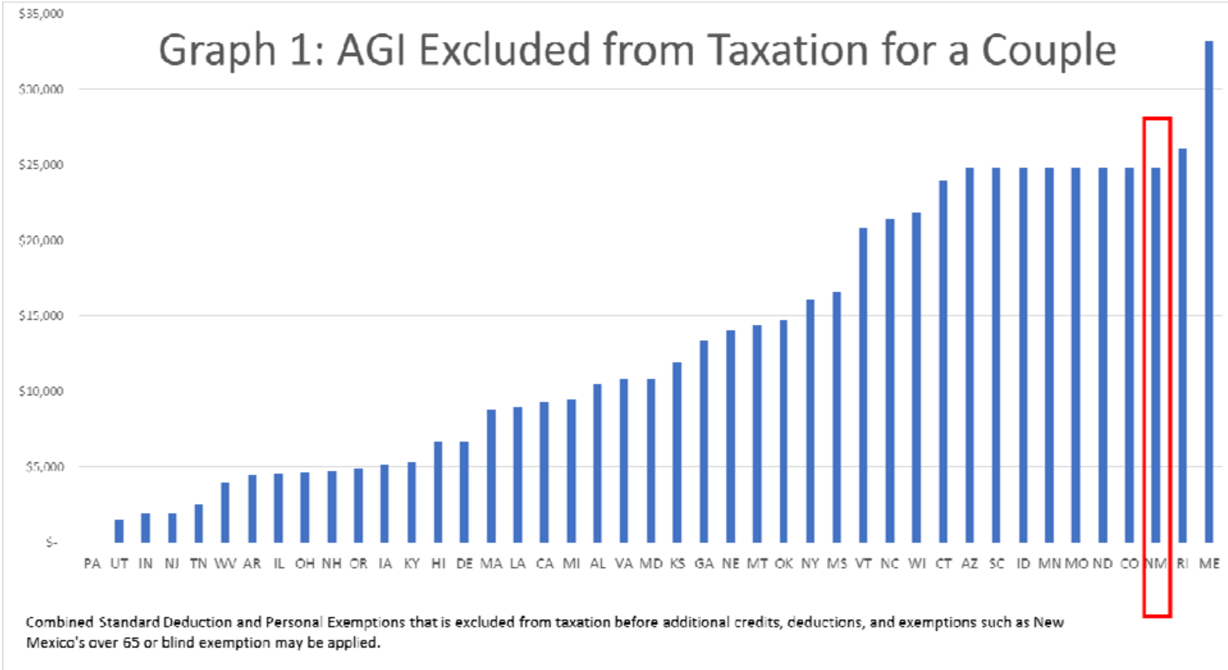
> Graph 1 below illustrates at what income level, a state's initial income tax rate takes effect for a couple's income. New Mexico, along with seven other states has the third highest income level, \$24,800 at which point a couple's income may be taxed. At the other end, Pennsylvania begins taxing a taxpayer's income at \$1 of taxable income. So, while New Mexico taxes retirement income including for military retirees, the state does not begin to tax a couple's income until the \$24,800 threshold.



There are many reasons why states may exempt some income for retirees, such as lessening the economic burdens for individuals on fixed incomes and trying to attract retirees to the state. As Graph 1 illustrates though, the consideration of exempting some retirement income and eroding horizontal equity and the progressive tax structure, must place it in context of the federal and state tax structure. In addition, a holistic look at New Mexico's tax code including property taxes and gross-receipts tax should also be considered. Finally, there are the necessary expenditures that this population faces especially in the area of health care and long-term care services in respect to quality, availability and costs.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met with the bill's requirement to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose. However, TRD will only be able to report on the number taxpayers claiming the deduction and the total cost of the deduction. If the purpose of the deduction is to provide an incentive for military retirees to stay in New Mexico, TRD would not have any data.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and create new publications, forms and regulations. Review and approval of the deduction will require manual intervention to confirm the information the taxpayer furnishes to prove eligibility for the deduction. Audit procedures will need to be updated to ensure proper reporting and training for auditors. These changes will be incorporated into annual tax year implementation and represent $15,405 in workload costs for the Information Technology Division (ITD).

NMDVS staff will have to be trained on the income tax deduction as it pertains to uniformed services members. NMDVS may play a role in determining eligibility for the tax deduction.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB169 is a duplicate of this bill.

TECHNICAL ISSUES

This bill does not contain a delayed repeal date. LFC recommends adding a delayed repeal date. It is by no means certain that this deduction would increase the number of retirees staying or relocating to New Mexico. It would be appropriate, considering this uncertainty, to provide a delayed repeal date which will encourage the legislature to review whether the deduction remains effective in the stated purpose.

OTHER SUBSTANTIVE ISSUES

Many years ago (the provisions were repealed in 1990), New Mexico provided two important income-source deductions. One was a full exemption for PERA and ERA pensions. The second was a fixed deduction of $2 thousand for federal civil service retirees. As the result of a US Supreme Court decision (Davis v. Michigan) and its local equivalent (Burns v. New Mexico), the differential treatment between state and federal retirees was held to be unlawful. This allowed the state the opportunity to repeal all income-source based deductions in favor of indexing personal exemptions and standard deduction amounts. This proposed deduction based on source of income puts New Mexico back into a position that it hasn't been in for almost 30 years.

A 2015 story in the Albuquerque Journal indicated that a recent study listed New Mexico as the 11th best state for military retirement. The study was conducted by WalletHub, a personal finance social network. Factors in the story by Jackie Johnson, Dated May 29th, 2015 included:

- New Mexico excelled in its health care category, ranking ninth. due to a few reasons. New Mexico has a really high number of VA health facilities per number of veterans, and it also has a high number of federal, state and local hospitals per one hundred thousand residents;
- New Mexico ranked seventh for its quality of VA hospitals;
- … although New Mexico ranked 30th for veteran job opportunities, it also ranked seventh for the number of military bases and installations per number of veterans, which goes a long way for the retirees. Living near a military base or installation allows retirees the most access to all of the benefits that they can take advantage of. They will be saving a lot of money on everything from airfare to working out exactly how they can maximize their pensions, and it also contributes to their quality of life by being around people who have gone through the same situations they have.

A current listing on the military.com website listed a total of five tax and financial benefits, three educational benefits and 6 recreation benefits accorded to veterans and their families.[1]

ALTERNATIVES

This is ultimately an economic development incentive. The idea is to bolster the competence and experience of the workforce by inducing military retirees with at least 20 years of technical experience to retire in New Mexico and take new jobs. In international experience, many countries allow direct foreign investment a five-year tax holiday. After that time, the recruited businesses are expected to pay their full and fair share. Perhaps, New Mexico could experiment

[1] https://www.military.com/benefits/veteran-state-benefits/new-mexico-state-veterans-benefits.html

with this concept and allow new retirees a five-year, 100 percent deduction of their military pension.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL?

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

This bill arguably fails the adequacy, efficiency, equity and simplicity principles. Accountability is also difficult, because although the utilization and cost of the deduction would be reported, there is no means of assessing whether the deduction (1) pays for itself in terms of additional tax revenues from additional retirees or (2) how many additional retirees can be attributed to the deduction.

Quick Facts About Veterans			
Veterans -- Civilian population 18 years and over			
	Total Number	148,264	
	% of New Mexico Population over 18 years of age	9.3%	
Veterans by term of service (% of all Veterans)			
	Gulf War (9/2001 or later) veterans	18%	
	1st Gulf War (8/1990 to 8/2001) veterans	21%	
	Vietnam era veterans	39%	
	Korean War veterans	8%	
	World War II veterans	4%	
	Other Periods	9%	
Veterans by Sex, Race & Ethnicity			
	Male Veterans (% of population 18 and over)	17.4%	
	Female Veterans (% of population 18 and over)	1.6%	
	Hispanic Veterans (% of Hispanic population 18 and over)	6.4%	
	Non-Hispanic Veterans (% of non-Hispanic population 18 and over)	11.8%	
Veterans by Age (% of all Veterans)			
	Veterans Percentage -- 18 to 34 years	8.8%	
	Veterans Percentage -- 35 to 54 years	21.8%	
	Veterans Percentage -- 55 to 64 years	20.1%	
	Veterans Percentage -- 65 to 74 years	27.4%	
	Veterans Percentage -- 75 years and over	21.9%	
Veterans Income			
	Veterans Median Income	$39,890	
	Non-Veterans Median Income	$24,178	
	Male Veterans Median Income	$40,403	
	Male Non-Veterans Median Income	$28,589	
	Female Veterans Median Income	(X)	
	Female Non-Veterans Median Income	$32,581	
Veterans by Educational Attainment		% of Total Veterans	% of Total Non-Veterans
	Less than high school	5.6%	14.8%
	High School (including equivalency)	23.8%	26.5%
	Some College or Associates	38.5%	31.6%
	Bachelor's Degree or Higher	32.1%	27.1%
Veterans by Poverty Status			
	Veterans -- Income in the past 12 months below poverty level	8.7%	
	Nonveterans -- Income in the past 12 months below poverty level	18.5%	
Veterans by Disability Status			
	Veterans -- With any disability	31.5%	
	Nonveterans -- With any disability	17.4%	

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