

# Vermont Legislative Joint Fiscal Office

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## *REVISED ISSUE BRIEF*

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### Military Retirement Income Tax Exemptions

#### Summary

Exempting military retirement pay from the State's personal income tax has been proposed by the Scott Administration for the past three legislative sessions. There have also been a number of bills introduced on the subject. This Issue Brief seeks to provide background information on the subject, including its cost and associated issues.

**Exempting military retirement pay from the State's income tax would result in \$2.9 million in lost revenue for the State in FY 2022 and growing slowly thereafter.** This works out to be approximately \$732 per year per military retiree. It is important to note that this proposal affects only military retirees, defined as service members who have served for at least 20 years, and not veterans who are service members who have served for any length of time. As of most recent data, Vermont had over 43,000 veterans but just over 3,900 military retirees.

The households expected to benefit from this exemption would vary significantly. Data on the income distribution of military retiree households in Vermont is not available, but generally, veteran households in Vermont have median incomes modestly less than the average household. This being said, the total tax benefit in dollar terms is likely to skew towards higher-income officer households. Despite representing only a quarter of military retirees in Vermont, they would receive the majority of the tax benefit.

There does not appear to be a correlation between state tax rates on military pensions and the overall number of military retirees in a state. Even if low taxes were an incentive to move or stay in Vermont, in order for the State to receive a return on its \$2.9 million annual expense, a significant number of military retirees and their families (likely greater than 300) would need to move to Vermont annually. For perspective, over the past 15 years, on average, 36 new retirees were added annually to Vermont's list of retirees.

Finally, the proposal creates a level of policy incongruence with Vermont's personal income tax system where tax liability is largely tied to one's ability to pay. An exemption for military retirement pay is limited to a specific group of people who have a certain type of income without regard to their ability to pay.

## **Background and Definitions**

The concepts of “military retirees” and “veterans” are often used interchangeably but they refer to different groups of people.

- A *veteran* refers to any person who has served any length of time in any military service branch. They may have served in combat or been medically discharged. Generally, this is an individual who has completed basic training.
- A *military retiree* is a veteran who has spent at least 20 years in uniformed service and has since left the service.

Military retirees are always veterans. Veterans are not always military retirees. The proposal in question would only affect military retirees, not all veterans.

As of the most recent data, Vermont had over 43,000 veterans<sup>1</sup> but just over 3,900 military retirees.<sup>2</sup>

Military retirees are paid a pension by the U.S. Department of Defense (DoD). In 2019, there were 3,904 military retirees in Vermont, 3,587 of which were being paid by the DoD. In sum, these retirees were paid \$81.7 million in pension benefits in 2019, for an average payment of \$22,776. This is modestly lower than the national average of \$28,416.

	Total	Paid by DoD	Annual Payment	Average
<b>Vermont</b>	3,904	3,587	\$81,696,000	\$22,776
Percent of Total Retirees	100%	100%		
<b>USA</b>	2,174,409	2,002,695	\$56,908,224,000	\$28,416
Percent of Total Retirees	100%	100%		

Source: U.S. Department of Defense Office of the Actuary, 2019

Military retirees’ pensions depend upon their rank upon retirement, retiring as either officers or enlisted service members. About a quarter of Vermont’s military retirees retired at the officer level. This tracks closely to the national average. However, average pension benefits for both Vermont’s officer and enlisted retirees are lower than the national average.

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<sup>1</sup> As of 2016.

<sup>2</sup> As of 2019

Table 2: 2019 Officer and Enlisted Retirees for Vermont and U.S.				
Officers				
	Total	Paid by DoD	Annual Payment	Average
<b>Vermont</b>	947	940	\$36,192,000	\$38,502
Percent of Total Retirees	24%	26%		
<b>USA</b>	549,892	544,500	\$25,029,888,000	\$45,969
Percent of Total Retirees	25%	27%		
Enlisted				
	Total	Paid by DoD	Annual Payment	Average
<b>Vermont</b>	2,957	2,647	\$45,504,000	\$17,191
Percent of Total Retirees	76%	74%		
<b>USA</b>	1,624,517	1,458,195	\$31,878,336,000	\$21,862
Percent of Total Retirees	75%	73%		

Over the past 15 years, the growth in the number of military retirees in Vermont has been slow. The number of retirees in a given state depends on many variables, including the age of the population, wars, the health of the economy, and importance of military installments. In 2019, there were only 502 more military retirees receiving benefits than in 2004 (15% growth). For comparison, the number of individuals receiving Social Security increased 39% over that same period.

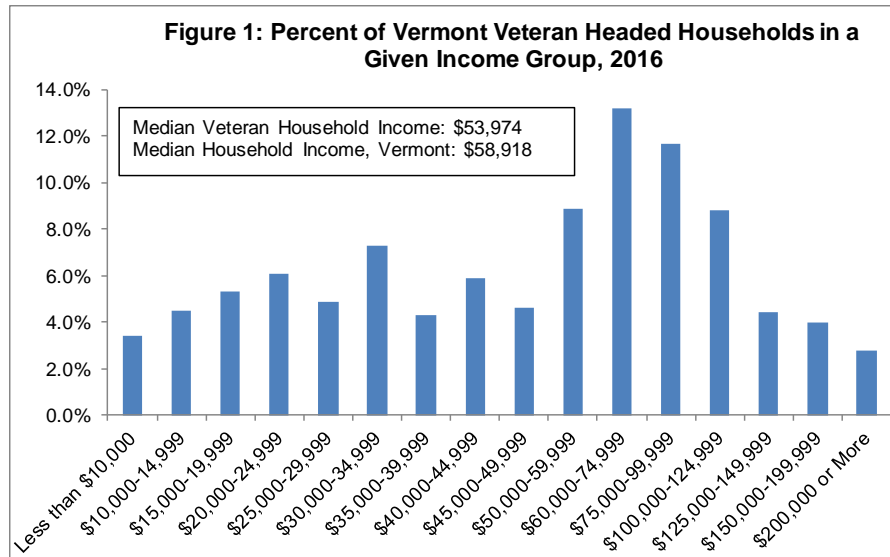
Table 3: Military Retirees in Vermont by Year								
Year	# of Retirees	Y/Y Growth	Paid by DoD	Y/Y Growth	Annual Pay (000s)	Y/Y Growth	Average Pay	
2004	3,402		3,162		52,512		\$16,607	
2005	3,456	1.6%	3,218	1.8%	55,500	5.7%	\$17,247	
2006	3,522	1.9%	3,284	2.1%	58,860	6.1%	\$17,923	
2007	3,603	2.3%	3,363	2.4%	62,232	5.7%	\$18,505	
2008	3,641	1.1%	3,406	1.3%	64,548	3.7%	\$18,951	
2009	3,746	2.9%	3,514	3.2%	70,092	8.6%	\$19,946	
2010	3,787	1.1%	3,561	1.3%	70,320	0.3%	\$19,747	
2011	3,785	-0.1%	3,554	-0.2%	70,500	0.3%	\$19,837	
2012	3,778	-0.2%	3,537	-0.5%	72,936	3.5%	\$20,621	
2013	3,763	-0.4%	3,516	-0.6%	73,272	0.5%	\$20,840	
2014	3,810	1.2%	3,551	1.0%	76,284	4.1%	\$21,482	
2015	3,851	1.1%	3,550	0.0%	77,652	1.8%	\$21,874	
2016	3,902	1.3%	3,583	0.9%	77,916	0.3%	\$21,746	
2017	3,904	0.1%	3,583	0.0%	78,144	0.3%	\$21,810	
2018	3,909	0.1%	3,593	0.3%	80,160	2.6%	\$22,310	
2019	3,904	-0.1%	3,587	-0.2%	81,696	1.9%	\$22,776	

Source: Department of Defense Office of the Actuary, Statistical Report on the Military Retirement System, Fiscal Year 2019

### **State Revenue Impact and Beneficiaries**

JFO estimates that exempting military retirement pay from the State's personal income tax would result in \$2.9 million in foregone revenue in FY 2022, increasingly slowly thereafter. The average tax benefit is approximately \$730 per military retiree.

On average, veteran (not military retiree) households tend to have modestly lower incomes than the average population although there is a significant variation across households (Figure 1).



This being said, based upon data from the Department of Defense, in Vermont, of the total \$81.7 million in pension benefits paid, \$36.2 million (or 44%) went to retired officers, who have an average pension of \$38,502. Because officer households are likely to have higher household incomes overall<sup>3</sup> (and therefore higher average tax rates), it is reasonable to assume that they account for the majority of the \$2.9 million in tax benefit, despite representing only a quarter of the population.

It is also important to note that most military retirees likely do not rely solely upon military pensions for their income. Their overall incomes could be greater than their pensions would suggest:

- At the national level, just over 70% of military retirees retired between the ages of 35 and 50, which indicates that most are still of working age at the time of retirement. 22% are aged 55 years or older.
- Since the requirement for a military pension is only 20 years of service, it's possible for a serviceman to join the service at age 20 and retire by age 40, in the prime of their earning years. Based upon data in 2016, 38% of officers and 51% of enlisted service members retirees were aged 40 to 64. For many of these retirees, their pension may just be a supplement to their working income.
- Military retirees also are eligible for Social Security. In 2018, 58% of Vermont retirees were above the age of 65 and their average military pension was \$20,633. Coupled with Social Security, these retirees could be earning an additional \$10,000 to \$20,000 in income. Some of that Social Security income is already exempt from taxes in Vermont.

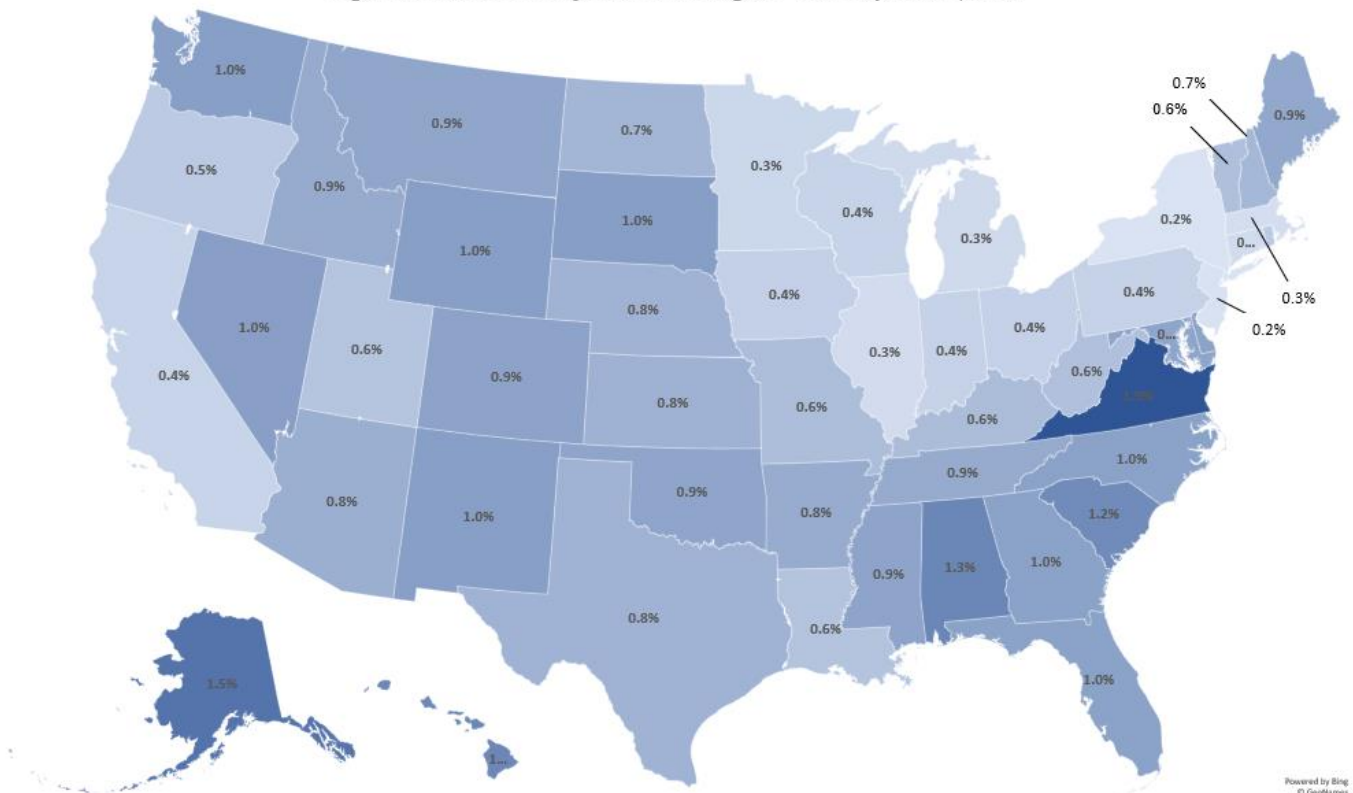
<sup>3</sup> Officers generally have increased training and education, in addition to higher pension payments.

## Other Considerations

It has been suggested that exempting military pensions from the income tax could be used to attract and keep military retirees in Vermont.<sup>4</sup> Based upon the data available to JFO, there does not appear to be evidence to suggest that the taxation of military pensions is causing migration from or preventing migration to Vermont.

Figure 2 shows each state's military retiree population as a share of its total population. Vermont's military retiree population is 0.6% of its total. New Hampshire, which has no income tax (and therefore, has the equivalent of a tax exemption on military pensions), only has a modestly higher share of its population composed of military retirees. New York, which offers a full exemption of military retirement pay, has three times fewer military retirees as a share of its population than Vermont. Overall, there does not appear to be a correlation between a state's military retiree population and its taxation of military retirement benefits.

Figure 2: Retired Military as a Percentage of Total Population, 2019



Moreover, in order for the State to receive a return on its \$2.9 million expenditure on attracting military retirees, a significant number of military retirees would need to move to Vermont. The Agency of Commerce and Community Development estimates that the median individual who

<sup>4</sup> Governor Phil Scott's budget address in 2020 stated "And to create an incentive for military veterans to return to Vermont and join our workforce, I'm once again proposing to exempt military retirement pay from the income tax." See here: <https://governor.vermont.gov/press-release/governor-phil-scott-delivers-annual-budget-address>

moves to Vermont generates \$4,450 in State tax revenue per year.<sup>5,6</sup> Assuming that the average military retiree were to contribute that amount of tax revenue for the State, in order to justify the \$2.9 million expenditure, 640 *new* military retirees would need to move to the State. This is distinct from and in addition to military servicemembers who already live in Vermont. For reference, since 2004, on average, there have been 36 new military retirees receiving benefits in Vermont<sup>7</sup> per year. Even if it is assumed that these retirees would bring an additional earning spouse, the State would not likely see a fiscal return on investment for at least 10 years, possibly more.

Finally, it should be noted that such a proposal is somewhat inconsistent with the Legislature's recent shifts towards a personal income tax system that is based upon a taxpayer's ability to pay. Tax rates are progressive and many of the exemptions and credits either have income thresholds or are capped for higher-income taxpayers (Earned Income Tax Credit, Social Security Deduction, Charitable Giving tax credit for example). An exemption for military retirement pay is largely an exemption for a certain group of people who earn income a certain way, without regard to their ability to pay.

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<sup>5</sup> See here:

<https://legislature.vermont.gov/Documents/2020/WorkGroups/Senate%20Economic%20Development/Economic%20Development%20Initiatives/W~Joan%20Goldstein~Impact%20of%20New%20Workers%20on%20Vermont%20Tax%20Revenues~3-1-2019.pdf>

<sup>6</sup> JFO has disputed this number, as some of the assumptions are moderately too high and the estimate does not account for increased State costs.

<sup>7</sup> Which is different from the number of military retirees who moved to Vermont. These new recipients may already have been living in Vermont.