

Senator Randy Brock
January 2022

A Critical Look of the Legislative Joint Fiscal Office's Analysis of Exempting Military Retirement Income from State Income Taxes in Vermont

Executive Summary

Vermont is one of just three states in the nation that fully taxes military retirement income.¹ In February of 2021, the Vermont Legislative Joint Fiscal Office (JFO) produced a report on the estimated effects of eliminating the state taxation of military retirement income. This report is concerning for several reasons. First, the report is inconsistent with more statistically robust studies conducted in other states. Second, the report contains several peculiar methodological assumptions relating to spousal considerations, distributional effects, and the net tax impact. Finally, the report uses a static view of military retirement migration, which ignores changes in migration over time in states that eliminated the tax on military retirement income.

Inconsistency with More Robust Studies

JFO's findings are inconsistent with the consensus of fiscal and economic analyses conducted in other states, both with higher and lower marginal state income tax rates than Vermont.

For example, the University of Arkansas's Institute for Economic Advancement completed a statistically robust study of the effects of exempting military retirement income from state income taxes.² This study used a REMI tax policy model under several different scenarios (with varying tax rates, levels of migration, etc.) and concluded that the costs of the tax incentive could be counterbalanced by the economic benefits in as little as seven years.³ A robustness check using the Implan Model found the same benefits could be achieved in as little as three years.⁴ Even in models using less favorable assumptions for migration, all simulations were able to pinpoint a definitive time at which exempting military retirement income from state income taxes would produce a net economic and fiscal benefit.⁵

A similar study conducted by the San Diego Military Advisory Council (SDMAC) found that, after ten years, the exemption of military retirement income would produce a net fiscal benefit to state and local governments of \$56.3 million after 10 years, and growing thereafter.⁶ Additionally, the SDMAC study estimates that 12,600 jobs would be created over the same period, adding \$830 million to the state's personal income, \$1.27 billion to California's Gross State Product (GSP), and \$2 billion to business sales.⁷

Other studies reached similar conclusions, including an analysis by the Arrowhead Center in New Mexico.⁸

Notably, these studies used 1) robust tax policy simulations and 2) estimates of GSP and macroeconomic effects, while the JFO analysis focused solely on state revenues. The SDMAC also considered local tax revenue implications, something JFO also ignored.

Concerning Methodological Assumptions

- **Spousal Considerations:** The JFO study included limited consideration of the benefits of bringing an employed spouse to Vermont. For example, using back-of-the-envelope math, JFO estimates that, at an average revenue benefit of \$4,450 per person, 640 new military retirees would need to move to Vermont in order to offset the \$2.9 million expenditure.⁹ However, if we use the Department of Defense’s statistics (which assume 47.6 percent of the military is married) then fewer than 435 new military retirees would need to move to Vermont, a 32 percent reduction compared to JFO’s figures.¹⁰ The true figures are likely even more favorable to exempting military retirement income from state income taxes when considering that retired military personnel tend to have higher marriage rates than the total force average reported by the Department of Defense.¹¹
- **Net Tax Impact:** The JFO uses the average Agency of Commerce and Community Development (ACCD) estimate that a new Vermonter generates \$4,450 in state tax revenue per year.¹² However, this figure is likely inappropriate for several reasons. First, as JFO itself notes, military retirees typically have multiple sources of income that distinguish them from members of the general population.¹³ Attracting military retirees would therefore tend to have a greater economic impact compared to the average civilian. Further, military retirees tend to require less governmental services, as they tend to have their own medical insurance provider.¹⁴ They also often are seeking a second career—indeed, JFO’s own reported figures suggest 38% of retired officers and 51% of retired enlisted members were below the age of 65.¹⁵ It is highly likely these retirees would be seeking additional employment and would help mitigate Vermont’s workforce shortage.
- **Distributional Effects:** The JFO notes the following:
“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). 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 (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.”
This analysis may be misleading for two reasons. First, according to reports from the Department of Defense, the proportion of military pension benefits going to retired officers (versus retired enlisted personnel) has slightly declined over the last several years.¹⁶ Second, as noted by JFO’s own figures, nearly 75 percent of veteran households make less than \$100,000 per year, further underscoring their likelihood to fall on the lower-to-middle end of the income distribution.¹⁷

Taxation and Migration:

The JFO asserts that “...*there does not appear to be evidence to suggest that the taxation of military pensions is causing migration or preventing migration to Vermont.*” This conclusion is incorrect for a number of reasons.

First, it conflicts not only with common-sense economic incentives behavior, but with other research on the issue. For example, the Pew Charitable Trust notes that “*Most veterans have lived in many places... While decisions on where to live might not be based only on tax rates, they’re a factor—and states know it.*”¹⁸

Second, the JFO uses a static analysis, comparing the percentage of retired military personnel by state in 2019. It notes that Vermont has a similar or higher percentage of military personnel relative to its total population compared to more tax-friendly northeastern states. However, a more accurate analysis would be to examine dynamic changes over time in states that adopt policies to eliminate taxes on military retirement income.

For example, in 2014, Iowa eliminated its taxation of military retirement benefits (retroactive for taxable year 2014).¹⁹ Between 2013 and 2020, Iowa saw its number of military retirees increase by 8.4 percent—more than double the state’s overall population rate over that same period (3.1 percent).²⁰ Meanwhile, Vermont’s growth in military retirees increased by just 5 percent over the same period, despite having a similar overall population growth rate to Iowa’s during that time frame.²¹ Unsurprisingly, the sharpest spike in Iowa’s population of military retirees occurred around the time the tax on military pensions was eliminated.²²

Using this type of dynamic approach takes into account changes in policy over time, and also implicitly controls for external factors (e.g. Virginia has a large number of military bases, so examining its military retiree population at any one point in time may be misleading—however, its population has remained relatively stable over the years).

Conclusion

JFO’s analysis is problematic, at best. Future consideration of eliminating taxes on military retirement income in Vermont should include at least several of the following:

- Use of a formal tax policy simulation or economic impact simulation;
- Dynamic comparisons of military retiree trends in states that eliminated military retirement taxes compared to a set of control states; and
- More granular estimates of the effects of military retirees moving to Vermont, including spousal considerations, the propensity to enter the Vermont workforce, and more.

¹ MilitaryBenefits, “States That Don’t Tax Military Retirement Pay,” [militarybenefits.info](https://militarybenefits.info/states-that-do-not-tax-military-retirement-pay/) (2022), <https://militarybenefits.info/states-that-do-not-tax-military-retirement-pay/>.

² Gregory Hamilton, “Analysis of the Fiscal Impacts Associated with Exempting Federal Military Retiree’s Pensions from the Arkansas State Personal Income Tax,” Institute for Economic Advancement (2015), <http://www.remi.com/wp-content/uploads/2017/11/408-UAR-Military-Pension-Exemption.pdf>.

³ Ibid.

⁴ Ibid.

⁵ Ibid.

-
- ⁶ San Diego Military Advisory Council, “Ending Taxation of Military Retirement Pay in California,” SDMAC (2018), <https://www.sdmac.org/media/uploads/Military%20Retiree%20Pay%20Tax%20Study/military.retirement.pay.study.finalpdf.pdf>.
- ⁷ Ibid.
- ⁸ Anthony Popp and Meghan Starbuck, “The Economic Impact of Exempting Retired Military Service Payments from New Mexico Personal Income Tax,” Arrowhead Center (2009), <https://arrowheadcenter.nmsu.edu/wp-content/uploads/2015/06/rmsp.pdf>.
- ⁹ Graham Campbell, “Military Retirement Income Tax Exemptions,” Legislative Joint Fiscal Office (2021), https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/fb3382a044/GENERAL-352502-v1-Military_Retirement_Exemption_Issue_Brief-v2.pdf.
- ¹⁰ See, e.g., Office of the Deputy Assistant Secretary of Defense for Military Community and Family Policy, “2020 Demographics Profile of the Military Community,” U.S. Department of Defense (2021), <https://download.militaryonesource.mil/12038/MOS/Reports/2020-demographics-report.pdf>.
- ¹¹ Gregory Hamilton, “Analysis of the Fiscal Impacts Associated with Exempting Federal Military Retiree’s Pensions from the Arkansas State Personal Income Tax,” Institute for Economic Advancement (2015), <http://www.remi.com/wp-content/uploads/2017/11/408-UAR-Military-Pension-Exemption.pdf>.
- ¹² Graham Campbell, “Military Retirement Income Tax Exemptions,” Legislative Joint Fiscal Office (2021), https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/fb3382a044/GENERAL-352502-v1-Military_Retirement_Exemption_Issue_Brief-v2.pdf.
- ¹³ Ibid.
- ¹⁴ Gregory Hamilton, “Analysis of the Fiscal Impacts Associated with Exempting Federal Military Retiree’s Pensions from the Arkansas State Personal Income Tax,” Institute for Economic Advancement (2015), <http://www.remi.com/wp-content/uploads/2017/11/408-UAR-Military-Pension-Exemption.pdf>.
- ¹⁵ Graham Campbell, “Military Retirement Income Tax Exemptions,” Legislative Joint Fiscal Office (2021), https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/fb3382a044/GENERAL-352502-v1-Military_Retirement_Exemption_Issue_Brief-v2.pdf.
- ¹⁶ Calculations based on DOD Military Demographics Reports over the last eight years.
- ¹⁷ Graham Campbell, “Military Retirement Income Tax Exemptions,” Legislative Joint Fiscal Office (2021), https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/fb3382a044/GENERAL-352502-v1-Military_Retirement_Exemption_Issue_Brief-v2.pdf.
- ¹⁸ Elaine Povich, “States Compete for Military Retirees,” Pew Charitable Trusts (2015), <https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2015/08/10/states-compete-for-military-retirees>.
- ¹⁹ Iowa Department of Revenue, “Military Retirement Benefits Exclusion from Iowa Income Tax,” State of Iowa (2021), [https://tax.iowa.gov/military-retirement-benefits-exclusion-iowa-income-tax#:~:text=Iowa%20Code%20sections%20422.7\(31A,regardless%20of%20a%20taxpayer's%20age](https://tax.iowa.gov/military-retirement-benefits-exclusion-iowa-income-tax#:~:text=Iowa%20Code%20sections%20422.7(31A,regardless%20of%20a%20taxpayer's%20age).
- ²⁰ Calculations based on DOD Military Demographics Reports and Census Bureau data.
- ²¹ Ibid.
- ²² Ibid.