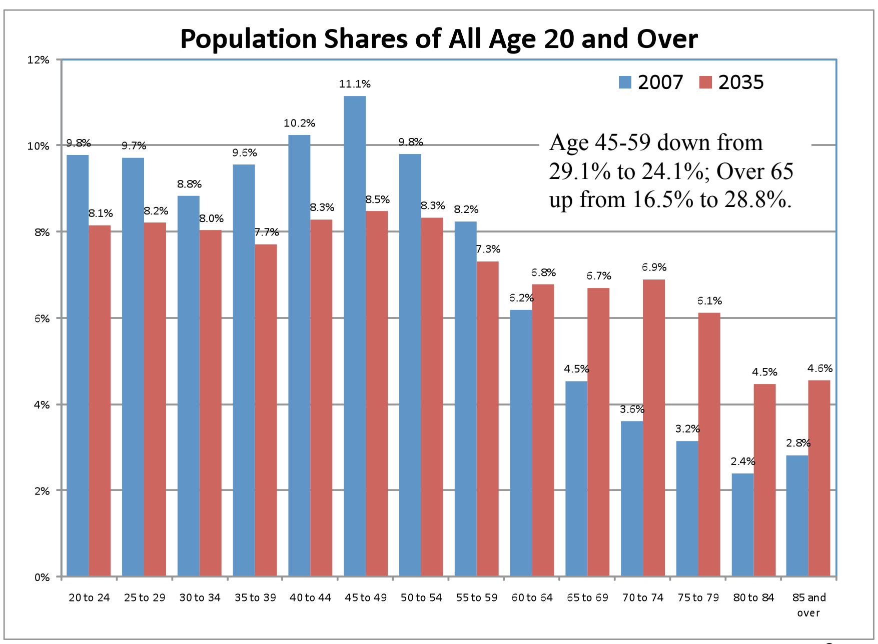
The Aging Population and State Income Tax Revenue: 2007 and 2035

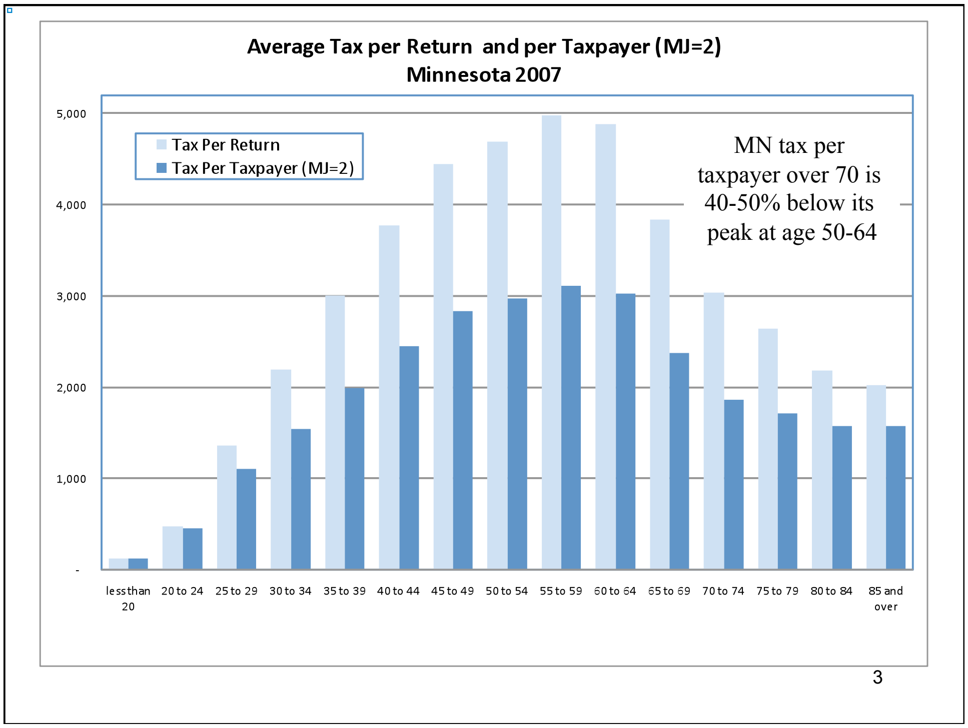
Beata Jajko and Paul Wilson

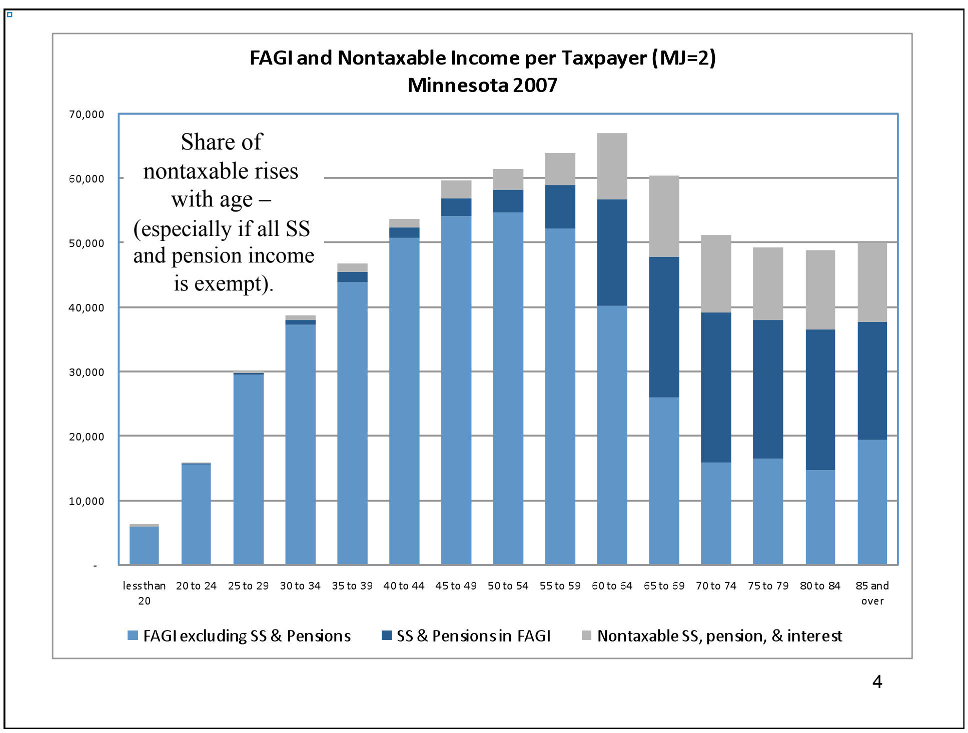
With valuable assistance from
Nina Manzi, Martha McMurry,
John Peloquin, and Joel Michael.

FTA Revenue Estimation & Tax Research Conference
Sun Valley, Idaho
September 21, 2010



2


Average Tax per Return and per Taxpayer (MJ=2)
Minnesota 2007
Tax Per Return
Tax Per Taxpayer (MJ=2)
MN tax per taxpayer over 70 is 40-50% below its peak at age 50-64
5,000
4,000
3,000
2,000
1,000
-
less than 20
20 to 24
25 to 29
30 to 34
35 to 39
40 to 44
45 to 49
50 to 54
55 to 59
60 to 64
65 to 69
70 to 74
75 to 79
80 to 84
85 and over
3


FAGI and Nontaxable Income per Taxpayer (MJ=2)
Minnesota 2007
Share of nontaxable rises with age – (especially if all SS and pension income is exempt).
70,000
60,000
50,000
40,000
30,000
20,000
10,000
-
less than 20
20 to 24
25 to 29
30 to 34
35 to 39
40 to 44
45 to 49
50 to 54
55 to 59
60 to 64
65 to 69
70 to 74
75 to 79
80 to 84
85 and over
FAGI excluding SS & Pensions
SS & Pensions in FAGI
Nontaxable SS, pension, & interest
4

Questions the Study Addresses:

- What would happen to MN tax revenues if:
  - the 2007 population had the same age distribution as projected for 2035;
  - the mix of 2007 income (by type of income) matches what is projected for 2035;
  - 2007 labor force participation rates matched those projected for 2035; and
  - 2007 tax law reflected current law for 2035?
- How would the impact differ if Minnesota provided more generous tax benefits for seniors (as many other states do)?

5

Research Strategy

Population	**2007**	
Total Real Income	**2007**	
Age Distibution of Population	**2035**	**15 age categories (State Demographer)**
Income Mix by Type of Income	**2035**	**GII 30-year trend, CBO, Social Security**
Labor Participation Rates	**2035**	**15 age categories (State Demographer)**
Tax Law	**2035**	**Same as 2007 except for effects of inflation**

6

So to compare 2007 to 2035

- Adjust age distribution of tax filers
  - Apply 2035 age distribution to 2002 total population
- Adjust labor force participation rates to 2035 levels.
- Adjust relative shares of income.
  - Grow different types of income/subtractions to 2035 levels, then adjust downward to match 2007 total income
- Control for inflation: Adjust un-indexed tax parameters downward for anticipated inflation

7

Description of dataset and model

- Stratified random sample of 2007 MN returns (35,000)
- Sample includes data from
  - Federal 1040 and Schedules
  - MN return
  - Federal tapes (Social Security)
- Sample includes taxpayer age (on 99.8% of returns) and separate wages of each spouse for joint returns.
- Analysis limited to full-time MN residents who report age
- Model grows income components and recalculates liability

8

Projected Changes in Labor Force Participation Rates (2007 to 2035)

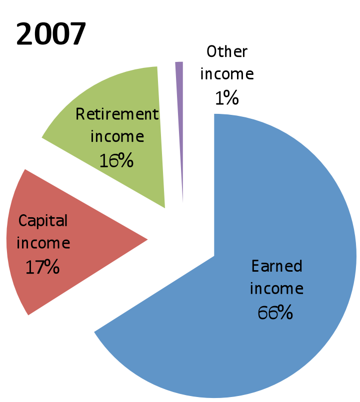
Age Category	Change in Participation Rate	
<20	-12.8%	
20-24	-1.4%	
25-29	1.8%	
30-34	1.9%	0.4%
35-39	-1.0%	
40-44		
45-49	0.8%	
50-54		
55-59	3.6%	
60-64	10.0%	
65-69	19.2%	
70-74	12.6%	18.20%
75-79	58.8%	
80-84		
85 or over		
All Ages	3.6%	

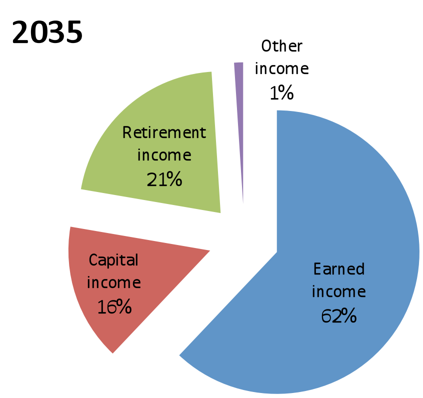
Non-workers replaced by workers, with same probability of becoming a worker whether non-worker was a single filer, filing jointly with a working spouse, or filing jointly with a non-worker spouse.

Worker = has wage income or (if no wage income) return reports sole proprietor or farm income.

9

Change in Mix of Incomes





Separately model 15 categories of income plus another 15 adjustment/deduction categories.

10

Results: Changes from 2007 base to 2035 projected

Earned income	-12.7%
Capital income	-9.5%
Retirement income	34.4%
Taxable retirement	*52.4%*
Taxable SS Inc	*118.7%*
FAGI	-1.2%
Exempt income	11.2%
Total income	0.0%
Tax	**-7.5%**

11

Impact on Tax Revenue Assuming Alternative Tax Law in *Both 2007 and 2035*

Baseline	-7.5%
A. $10K pension subtraction, not indexed	-8.4%
B. $10K pension subtraction, indexed	-8.9%
C. Full pension subtraction	-10.9%
D. No tax on social security income	-10.5%
B. plus D. (typical state)	-11.4%
C. plus D. (most generous states)	-12.6%

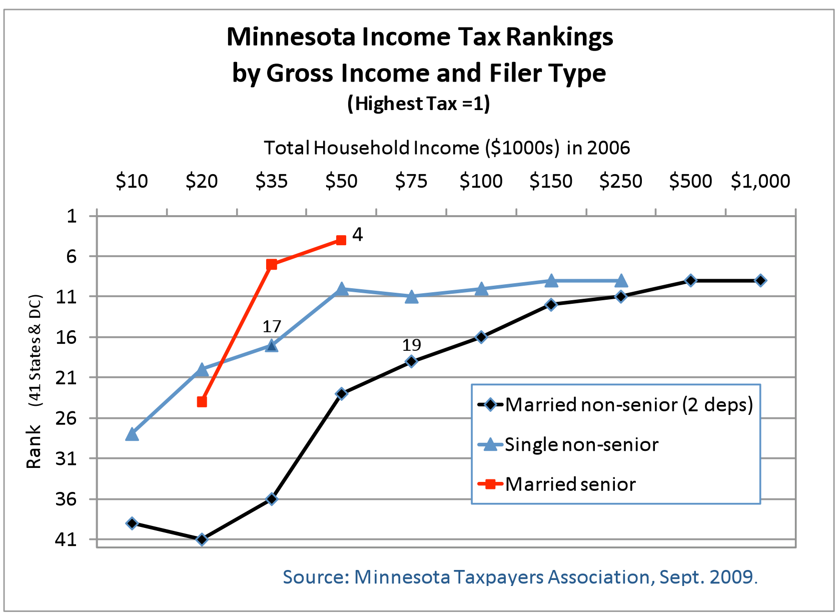
The more generous to seniors now, the bigger the fall, but …

12

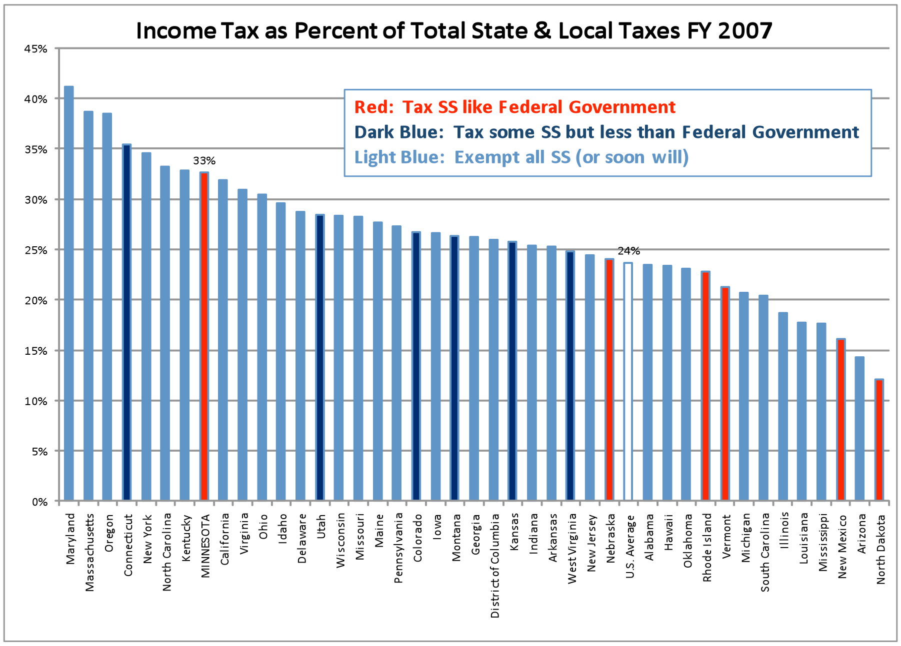
Impact on Tax Revenue If Minnesota Tax Law Changes in 2035

Baseline	-7.5%
Social Security thresholds indexed to 2007	-9.0%
A. $10K pension subtraction, not indexed	-10.1%
B. $10K pension subtraction, indexed	-11.4%
C. Full pension subtraction	-18.0%
D. No tax on social security income	-13.0%
B. plus D. (typical state)	-16.2%
C. plus D. (most generous states)	-21.3%

… if less generous now, the *potential* loss is larger in the future. 13



Pressure to match tax breaks in other states may be severe. 14



15

Conclusion

- Even states that follow federal law and limit senior preferences (such as Minnesota) will face substantial declines in income tax revenue (7.5%) due to the aging population.
- Decreases are likely to exceed 10% in the many states that exempt social security and provide generous pension exclusions
- States with limited senior preferences (like MN) face an even greater potential loss, given the likely pressure to match tax breaks in other states.

16

Why do these results differ so much from the 2002 to 2030 analysis?

- More complete impact of aging (2002 to 2030 still saw increase in share of taxpayers in their 50s)
- Recession year (2002) as base year meant more growth in capital income (and wages) relative to retirement income. Loss due to aging was hidden.
- Differing long-run forecasts (GII, CBO)
  - Lower pension growth (5.7% of GDP vs 7.4%)
  - Lower inflation (cumulative 66% rather than 100%)

17