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Income Tax Breaks for the Elderly—How Did We Get Here?

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Every state that has a personal income tax offers some form of preferential treatment of elderly tax payers. In fact, our recent study estimates that non-elderly, high income households pay approximately twice as much state income tax as an equivalent elderly household (Conway and Rork, 2008a). The federal government also offers preferential treatment, although federal tax breaks tend to be more modest and have shown a consistent decline in recent years. The 2008 presidential campaigns, however, suggest a reversal in this recent trend as both candidates offered additional federal tax breaks to the elderly, the most notable being Senator Obama's proposal to eliminate all federal income taxes on senior citizens with incomes less than \$50,000.

Elderly tax breaks cost the state and federal governments billions of dollars a year. For instance, a recent study found that exempting Social Security benefits from state taxation cost the state of California \$850 million in 1999 (Bernstein, 2004, p. 9). With the aging of the population, the costs of these tax breaks are certainly going to increase in the future. And yet, the rationale for these tax breaks is far

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Federal Taxes and the Elderly

Rudolph G. Penner

Society favors the elderly in many ways. They receive movie discounts, low cost transit tickets, senior airline fares (sometimes), and a host of other discounts, particularly if one is a member of the AARP. Those who write tax law are also very kind to their elders. State and local levels of government are particularly generous and often provide credits against real estate taxes, and partial or full tax exemptions for pensions and Social Security (Penner, 2000). The Federal government does not have many tax provisions that explicitly mention age, and not all that refer to age are beneficial, but tax law clearly favors Social Security income and saving for retirement. A few other minor provisions explicitly favor the elderly, but they are used by relatively few taxpayers. There are also proposals for tax reform that would disproportionately affect the elderly, almost by accident. For example, if society decides to rely more heavily on taxing consumption rather than taxing income, retirees will see their relative burdens increase because they generally consume a higher proportion of income than workers, and sometimes they consume more than 100 percent of income. Lastly, although they are not affected by it, the elderly have a considerable interest in estate taxation.

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from clear. The desire to help a needy, deserving set of taxpayers is frequently given as a reason. As a group, however, the elderly enjoy a lower level of poverty and more economic security in the form of government programs (Medicare, Social Security) than other segments of the population. Furthermore, because these tax breaks are typically nonrefundable deductions and exemptions, their tax savings increase with one’s marginal tax rate. Therefore, it is the wealthiest elderly households who benefit the most. Some have suggested that the high income elderly are indeed the intended target by these policy makers, as they attempt to attract and retain financially secure retirees as part of an economic development strategy. In the last three years, at least four states (Georgia, Iowa, Missouri and Wisconsin) have reduced their income taxes on elderly taxpayers and attracting/retaining the elderly has been a prominent theme in these policy actions.

How Did it All Begin?

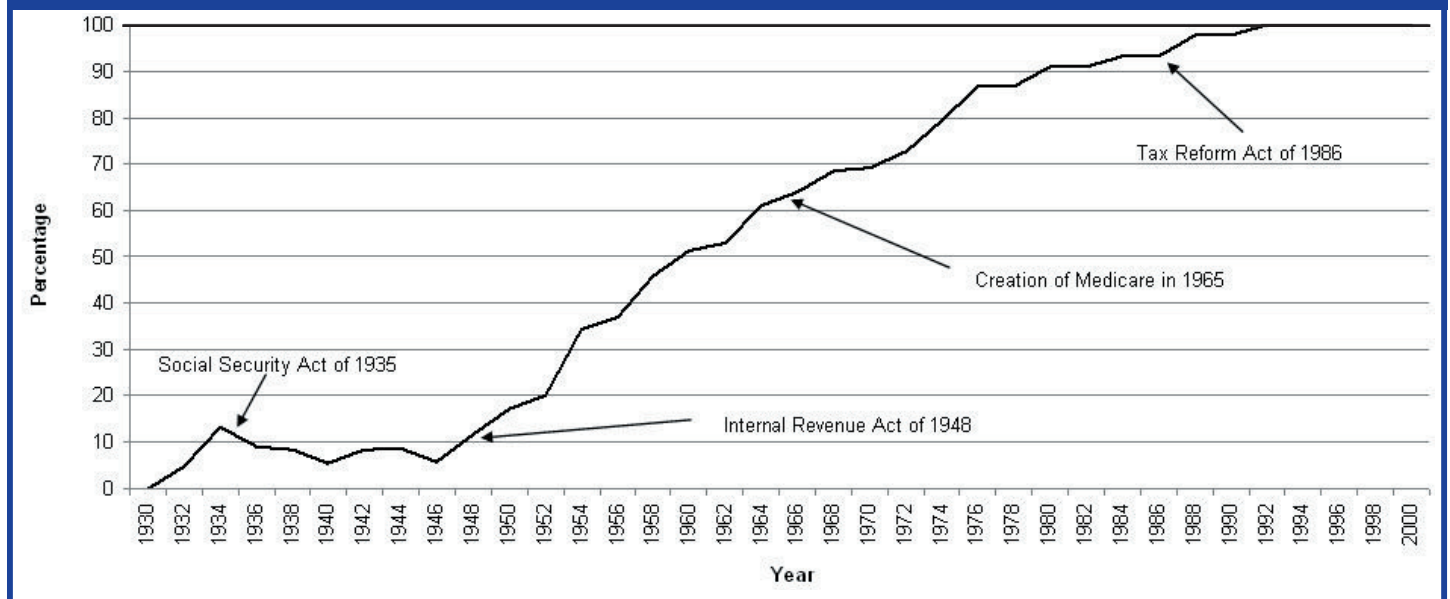
To better understand why these tax breaks exist, it is instructive to look at how they first began.¹ One might think that such tax breaks have always been part of the income tax code or that the states have simply followed the lead of the federal government. Neither is the case. The federal income tax was

enacted in 1916 and yet the first federal elderly tax break – an additional exemption (of \$600) for each taxpayer age 65 or older – was not enacted until 1948. Furthermore, the first elderly tax preferences occurred at the state level in the 1930s when the majority of states enacted their income tax systems. And yet, widespread adoption of such preferences did not occur until a decade or so after the federal exemption became law, and they have continued to expand and proliferate beyond those offered by the federal government. So exactly how and why did these tax breaks begin?

At the beginning of the 20th century, the life expectancy for a white man (woman) was 48 (51) and less than 5 percent of the population was over age 64 (Costa, 1998). Labor force participation rates were also much higher than today, as more than 60% of those aged 65 and over were “gainfully employed.” Perhaps not surprisingly then, government treatment of the elderly was also quite different. In 1915, state estate, inheritance, and gift (EIG) taxes were more prevalent than income taxes, and the first state-funded (but voluntary) old age insurance (OA) programs – a precursor to today’s Social Security – were enacted in Arizona and Alaska.

Between 1915 and 1929, the number of states with income taxes or OA programs grew modestly, while state EIG taxes came under strong attack as advocates argued that such taxes would

Figure 1 Percent of Income Tax States with an Elderly Tax Preference



cause them to lose their wealthy (and presumably elderly) constituents (Cooper, 2006). In fact, the 1926 enactment of the federal state EIG tax credit (commonly known as the “pick-up” or “soak-up” tax, whereby state estate taxes are credited against the federal liability) was in direct response to the states’ pleas for help in ending this “race to the bottom.” This period, then, marks the first appearance (to our knowledge) of policy competition over the affluent elderly. It also marks the beginning of the public pension movement – the first political movement to deal with old-age dependency (Pratt, 1976).

The next five or six years, 1929-35, saw many changes beyond the obvious impact of the Great Depression. It is during this period that we see the first elderly income tax breaks, although many were subsequently repealed. Eighteen states enacted income tax systems between 1929 and 1935; 8 enacted income taxes in 1933 alone. Yet, the adoption of elderly tax breaks shows no clear pattern and was far from universal. Vermont included a pension income exclusion in 1931 as part of its new income tax. South Dakota behaved similarly two years later when it enacted its short-lived income tax (which was repealed in 1943). In the same year, New Mexico enacted an elderly deduction as part of its new income tax, and South Carolina added one to its existing income tax. Oregon added an income tax credit to its existing tax code in 1934, and South Carolina repealed its break in the same year. By 1936, only 3 of 33 states with income taxes included tax breaks for the elderly. This number remained largely unchanged until the first federal tax break came into existence in 1948. Then, while some states adopted elderly tax breaks as part of their new systems, others chose not to, while still others decided to add them to their existing systems. It is therefore not the case that elderly tax breaks have always been part of the income tax, at either the federal or state level. Moreover, the movement to include these breaks stalled for more than a decade after its beginning.

This period was also marked by a tremendous growth in state-funded mandatory public pensions and the public pension movement. After emerging as a political issue in the 1920s, the first statewide

mandatory old-age pension programs were enacted in California and Wisconsin in 1929. By 1934, 28 states plus two territories had enacted old-age pension programs. The Social Security Act of 1935 (SSA35) further encouraged state old-age programs by offering federal subsidies for old-age assistance. Social Security benefits were not subject to income taxation through what some scholars call “an historical accident” (e.g., Groves, 1963). In one sense, then, SSA35 marks the first federal elderly tax preference, although it was not enacted in the deliberate manner of subsequent federal tax breaks or preceding state ones.

Twelve months after SSA35, 36 states plus DC had developed old-age programs – and state-level OA programs

continued to grow in both benefits and reciprocity rates until their peak in 1950 (Costa, 1998). The early pension movement in the 1920s evolved into larger movements, the most notable being the Townsend Movement. The Townsend Movement was named after a California physician whose main proposal was that every person over age 60 receive \$200 a month (which was more than twice the earnings of full-time workers), provided the money was spent within month of receipt (Costa). Although we have been unable to uncover any links between this movement and the adoption of the first elderly tax breaks, it seems likely that it at least contributed to their adoption. Moreover, after peaking in the late 1930s, the Townsend Movement fell off dramatically in the early 1940s (Pratt, 1976), which coincides with the lull we observe in the spread of elderly tax breaks.

The Post-War Explosion in Elderly Tax Breaks

While the spread of elderly tax breaks stalled in the late 1930s and early 1940s, the federal income tax was dramatically broadening its tax base. For instance, Seltzer (1968, p. 60) notes that the population covered by the income tax rose from approximately 5 million in 1939 to nearly 100 million by the early 1940s. This broadening, along with the increased cost of living that resulted from World War II, likely set the stage for the first federal elderly income tax preference. The Internal Revenue Act of 1948 (HR 4790) was a broad, Republican-promoted

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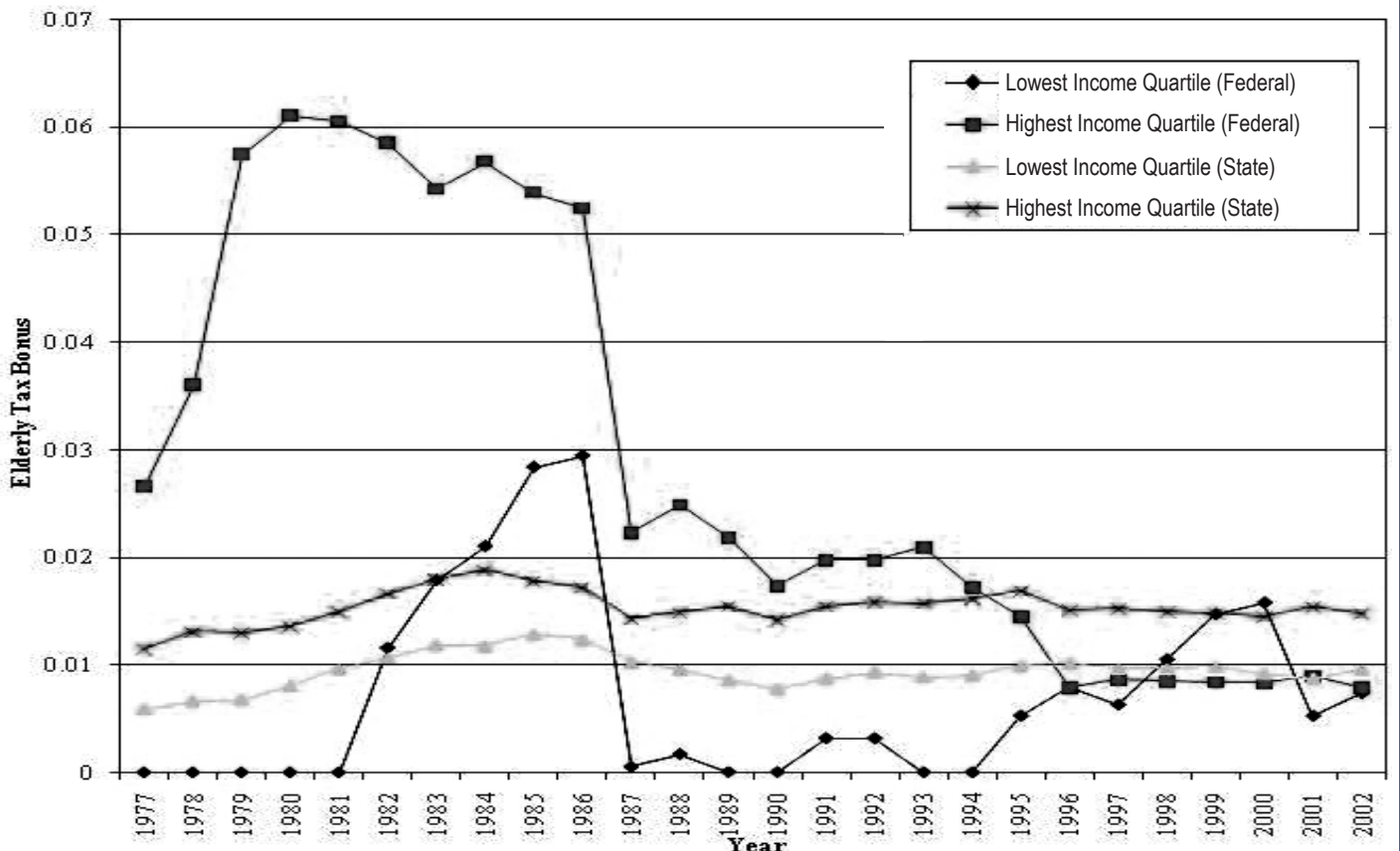
tax reduction bill enacted over President Truman’s veto. A response to a broadening of the tax base and budget surpluses, it included an additional exemption of \$600 for each taxpayer over the age of 65. The arguments given in favor of the provision were based on the premise that increases in cost of living had hit the elderly especially hard: “...This group of individuals for the most part are not acceptable for full-time jobs at prevailing wages, and therefore, are in need of this extra exemption and consideration in view of the present high cost of living,” (*Revenue Act of 1948, Legislative History Series*, p. 97). It is interesting to note that the tax exempt status of Social Security benefits was also given as a justification. The new exemption was offered as a simple way to compensate those who received retirement income from sources other than Social Security.

The provision also had its opponents: “The special exemption of \$600 for persons over 65 years of age, except for political considerations, can be justified only upon the ground that an aged person

has a higher cost of living than does a person under 65. The necessary personal expenditures of the aged person are certainly no higher than those of a younger person engaged in active employment and receiving the same income,” (*ibid*, p. 95). Also “All low-income taxpayers have suffered severely from high prices and it would be inequitable to grant additional income-tax relief to those over 65 years of age and to deny it to those under 65 years of age who are equally hard-pressed,” (*ibid*). The dual arguments that the elderly have a lower cost of living, if anything, than younger taxpayers and that tax relief should be extended to all low income taxpayers persisted well after the passage of the bill into the 1950s and 1960s (e.g., Groves 1963; many chapters in the *1959 Tax Revision Compendium*).

Nonetheless, elderly income tax breaks proliferated at both the federal and state levels after 1948. In 1951, the elderly were excluded from the 5 percent floor on deductible medical expenses, the result being that households with at least one elderly

Figure 2 Federal and (Average) State Elderly Tax Bonus



taxpayer could deduct all medical expenses from their federal income taxes whereas the non-elderly could only deduct those that exceeded 5 percent of their income. In 1954, a retirement income credit was introduced and was “aimed at parity privileges for those not covered by Social Security,” (Groves, 1963) even though the lack of parity was one of the justifications given for the extra exemption granted in 1948. The states also began granting elderly income tax breaks in rapid succession, as shown in Figure 1. Between 1947 and 1954, eleven states enacted new exemptions, deductions or credits for the elderly, and in 1954 Hawaii exempted all pension income, which persists to this day. By 1954, more than one-third of states with income tax systems, 12 out of 35, offered elderly tax breaks.

The proliferation of state tax breaks continued, however, beyond 1954. Over the next twenty years, nearly every year saw at least one state add a new elderly tax break. States that enacted income tax systems for the first time, such as Michigan in 1967, and Illinois and Maine in 1969, routinely included at least one elderly tax preference in their new systems. (Illinois and later Ohio enacted both an elderly deduction and a pension income exclusion as part of their new codes.) By the early 1970s, nearly three-quarters of states with income tax systems offered elderly tax breaks.

This growth in tax breaks coincides with several other relevant policy and political trends. The state-level OA programs were largely taken over by a rapidly expanding Social Security program, with the proportion of the elderly covered increasing from 17 to 62 percent during the 1950s. As the responsibility for public pensions shifted from the states to the federal government, medical assistance for the elderly became a growing concern for the states. State and local expenditures on medical assistance for the elderly increased by more than 1,000 percent between 1960 and 1965 alone (Costa, 1998, p. 177), culminating in the enactment of Medicare in 1965. Once again, the responsibility of caring for the aged shifted from the states to the federal government.

Perhaps most notably and not coincidentally, the 1950s were also the birth of the modern day senior movement. Pratt (1976) notes that it was “a prelude... to a time of marked activism among the aging, involving the emergence in the sixties of politically influential, mass-based organizations and interest groups.” The AARP was first founded

in 1958, having evolved from the National Retired Teachers Association (NRTA) which was, interestingly enough, formed in 1947 (AARP History, n.d.). While it has been widely acknowledged that this political movement corresponds closely with the growth in Social Security and eventual enactment of Medicare, the fact that elderly income tax breaks also grew during this time period appears to have been mostly overlooked.

The States and the Federal Government Part Ways – Or Do They?

Beginning in the late 1970s, the federal government began to enact policies to solve the financial problems that had begun to emerge with regards to Social Security. The tax base was expanded, benefit increases were reduced, and in 1983 Social Security benefits began to be subject to federal income taxation for the first time since the program’s inception. The Tax Reform Act of 1986 (TRA86) further reduced the value of elderly income tax breaks by reducing the relative size of the elderly exemption, switching it to an additional standard deduction that could only be claimed by non-itemizers, and reducing marginal tax rates overall. In 1993, the taxation of Social Security benefits was further expanded such that up to 85 percent of benefits paid to high income households could be subject to tax.

While the states followed the federal government in some ways, they clearly diverged in others. As many as 18 states followed the federal government in taxing Social Security benefits, although as noted in the introduction, that number has fallen. Most states also adopted similar provisions to those put forth in TRA86, therefore also reducing the value of the additional exemptions and deductions offered to their elderly constituents. Conversely, the number of states offering pension income exclusions, as well as the size of the exclusions, has grown tremendously. In 1964, two states – Delaware and Hawaii – had such an exclusion. By 1994, the year after the federal government had once again increased taxes on Social Security benefits, the list had grown to 24. (In 2006, the list had grown to 28, five of which fully exempt pension income.) In general, as shown in Figure 1, the proportion of states offering elderly tax breaks continued to grow, reaching 100 percent in 1992.

As the prevalence and types of elderly tax breaks grows and states differ in their tax treatment

of Social Security benefits, comparisons over time and across states becomes increasingly difficult. In a recent study, we address this issue by constructing a summary measure of the “tax bonus” associated with being elderly (Conway and Rork, 2008a). Briefly, we constructed a representative high income (top quartile) and low income (bottom quartile) elderly household, as well as non-elderly households with the same respective incomes, for each year from 1977-2002 using data from the Current Population Survey. The elderly vs. non-elderly households therefore vary only by age and the sources of their income (e.g., the non-elderly household has few Social Security benefits and much higher wage earnings). We then estimated the federal tax liability and the liability in each state every year for these typical households using the publicly available TAXSIM calculator (Feenberg and Coutts, 1993). Because both incomes and tax liabilities grow over the 25-year period, we divide the estimated tax liabilities by the household’s income to calculate the average income tax rate paid. We measure the “tax bonus” for being elderly as the difference in the average tax rate between equivalent non-elderly and elderly households.

Figure 2 reports the federal and the average state tax bonuses to high income and low income elderly from 1977 to 2002. It is immediately apparent that the federal tax benefits for the elderly have declined sharply over this period, especially as a result of TRA86. In contrast, the average state tax bonus has remained fairly constant. This suggests that the declines in state tax breaks resulting from the states following the federal government (taxing Social Security, reducing deductions) have been offset by the expansion of pension exclusions. Another salient finding is that the tax bonus is consistently higher, especially for the states, for high income households. Recall that the bonus is expressed as a proportion of income; therefore, high income households are receiving *proportionately* greater tax benefits for being elderly than lower income households are. This finding is expected, given that most tax breaks are not refundable and their value increases with one’s marginal tax rate. Our analysis therefore confirms that 1) the federal and state income tax systems have diverged in their treatment of the

elderly in recent years, and 2) elderly tax breaks disproportionately benefit high income households.

Why did the states continue their generous tax treatment while the federal government’s declined? One answer may be found in Conway and Rork’s (2004) description of a renewed “race to the bottom” in state EIG taxes beginning in 1976, as well as in recent statements by policy officials in proposals to reduce the income taxes of seniors. Since 1976, more than 30 states have eliminated their EIG taxes (above that permitted by the federal tax credit) and several more have reduced them; interstate tax competition over the elderly seems to be responsible. Recent

statements made by policy makers make it clear that tax competition is playing a role in the recent wave of new state elderly income tax breaks:

“There is active recruitment by some states to lure retirees to locate in other states. A state’s tax burden is one of the top three reasons to move to a state,”

explains a policy statement regarding a recent Missouri bill to reduce taxes on Social Security benefits (Special Committee on Tax Reform, Missouri House of Representatives, 2006).

“Unfortunately, one of our most cherished treasures – our retirees – are leaving in favor of more tax-friendly states,” writes Dave Nabity, a 2004 candidate for governor of Nebraska (Nabity, 2004).

“This tax cut will allow seniors to better cover the costs of prescription drugs and health care, or spend more time with their families. [...] It will help attract retirees to our state and make our economy even stronger,” says Sonny Perdue, a Georgia governor who has sought to cut or eliminate retirement income taxes (Salzer, 2007).

It therefore appears that states have continued to expand their elderly tax breaks, despite the federal government’s retrenchment, at least in part out of an effort to attract/retain their elderly constituents. Now, however, the federal government seems to be reversing its course, even before the elderly tax

“...States have continued to expand their elderly tax breaks, despite the federal government’s retrenchment, at least in part out of an effort to attract/retain their elderly constituents.”

breaks proposed in the recent presidential election. Interestingly, unlike its response to the state EIG tax crisis in the 1920s, the federal government phased out the credit – and the federal estate tax overall – in 2001. Medicare Part D, enacted in 2003 and effective January 1, 2006, covers for the first time prescription medications and represents the first major expansion of Medicare elderly benefits since its inception.

History Lessons

Income tax breaks for the elderly seem to track fairly well other government benefits for the aged, such as reduced EIG taxes, public pensions and health insurance for the elderly. They first emerged at the state level at a time when the public pension movement was growing and the states had just recovered from intense state EIG tax competition over the wealthy elderly. Tax breaks at the state level, however, didn't become common until the federal government began offering them, after which time they spread widely. This expansion coincided with both the growth in the modern day senior movement and the shifting of responsibilities for the aged from the states to the federal government. This shift likely made the elderly more attractive constituents and may have lead to intensified interstate tax competition. Such tax competition may help explain why the states have diverged from the federal government in recent years, continuing to offer more tax breaks at the same time the federal government has reduced them. The resurgence in federal benefits since 2001, however, is evidence that other forces, such as political pressures, must be at work as well. Why the federal government is apparently reversing itself and whether it will continue to do so remains to be seen.

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coherent manner, and to Public Finance Review/Sage for their permission to reprint Figure 2. The authors are also grateful to Aliya Sassi who did a superb job of investigating historical documents outlining the circumstances and reactions to the adoption of these policies.

Endnote

¹ For a more detailed accounting, see Conway and Rork (2008b), on which much of this discussion is based.

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