

# THE IMPACT OF STATE INCOME TAX BREAKS FOR THE ELDERLY ON SAVINGS AND INCOME SECURITY

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This study provides the causal effects of the state retirement income exemption policies on saving for retirement and their long-term impact on income in retirement, which have been under-studied. This project found a 26 percent decline in savings into retirement plan accounts in post-policy periods. Workers in states with exemption offers were also less likely to save compared to those worked in states without such exemptions. The fall in household income (both before and after-tax) in retirement further implies that seniors in exemption states were not better off than their counterpart states. Hence, it may be an opportune time for states to examine the effectiveness of these policies.

## State Retirement Income Tax Exemptions Policies (SRITE)

State policies on retirement income<sup>1</sup> exclusions vary substantially, ranging from exempting all sources of retirement income to moderately deducting a small portion from state taxable income tax base. These exemptions serve one or both of two purposes: to secure the income of taxpayers who exit the labor force; and to serve as a means of attracting or retaining retirees in a state. Research on these state income tax reliefs to older adults are limited, and most research examined how the state income tax policies affected the overall effective tax rates facing elderly taxpayers (Forman, 1995; Penner, 2000; Wheeler, 2000; and Edwards and Wallace, 2004); and the consequences of such tax preferences on state revenue and elderly migration across states (Conway and Rork 2008, 2012, 2014; Pan and Wagner, 2011; Onder and Schlunk, 2015; Brewer et al., 2017).

This study uses data from the RAND Health and Retirement Study (HRS) Longitudinal data and the RAND HRS Tax Calculation, both of which are linked to confidential HRS and Administrative W2 data. In this study, I compare the changes in states that provided retirement income exemptions (HI, IL, MS, PA, AL, DC, GA, MO, MT, NJ, NY, LA, IA, KY, AR, OK, DE, ME, MI, WI, CO, NC, and SC) to states that did not offer such exemptions (the rest of the U.S., excluding states without income taxes<sup>2</sup>). Specifically, the study measures contributions to tax-deferred retirement accounts, “crowd-out” effect parameters (Individual Retirement Account (IRA) accounts and traditional savings accounts – taxable savings account), and income in retirement including total

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<sup>1</sup> Retirement income is defined as the income distributed from employer-sponsored retirement accounts and their annuities such as 401(k) and IRA.

<sup>2</sup> Nine states without state income taxes includes FL, AK, NH, NV, SD, TN, TX, WA, and WY. Noted that TN only imposes income tax at state level for capital income. So, I treat TN as a no income tax state.

household income, retirement income, Social Security benefits (retirement income, SSDI, and SSI), capital income, and other government transfer income.

## Effects on Savings in Retirement Plans

- SRITE policies were associated with a reduction in depositing to private retirement accounts by roughly \$606 (in 2016 real dollar) or 24 percent after the policies were enacted, and by \$731 (or 10 percent) conditioning on a positive contribution.
  - The contribution as a share of gross wage is estimated to have declined by 0.1 percentage point, meaning a \$1 increase in gross wage would have led to a fall by 1 cent in contributions.
- In examining the “crowd-out” effects on savings vehicles (i.e., savings in taxable accounts), there is no evidence that taxable savings increased following the SRITE policies, compared to states without exemption.
- In states with the SRITE policies, workers tended to work less such that the gross wages fell by the amount of reduced savings, and their “take-home” did not change, though the estimate for the gross wage is marginally statistically significant.
- Higher educated groups and coupled households were more responsive to the policies.

## Effects on Income in Retirement

With regard to income in retirement, several findings are highlighted:

- Income in retirement distributed from employer-sponsored retirement plans is estimated to fall by \$907 (or 11 percent) using the individual sample, and by \$765 (or 6 percent) using the household sample (though the household-level estimate is statistically insignificant)
- Other income sources are found with mixed results. Both Social Security Retirement and Supplemental Security Income (SSI) did not decline; incomes from other social programs (included welfare and food stamps) increased by 21 percent in states with SRITE policies. In contrast, capital income fell substantially by 22 percent.
- Total household incomes, both before and after-tax, are estimated to have fallen by 14 percent and 9 percent respectively.

## Implications

The exclusion of retirement income from state income tax base seems to fail its target as a means to retain income for seniors.

- The policies neither encourage workers to save for retirement nor encourage them to participate in retirement plans. Further, these policies unintentionally induced workers to work less during the working period.
- Total household income, both before- and after-tax, fell following the exemption policies (though mostly driven by a decline in capital income), and suggests a negative “spill-over” effect on other financial assets.

Overall, the tax incentives were not effective in promoting savings for retirement.

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