



***Analysis of the Economic Impact of the Exemption of Military Pension Income
from South Carolina Income Tax***

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Summary Overview

This document provides an analysis that estimates the fiscal impact that would result from a reduction in taxable income for individuals with retirement benefits attributable to service in the Armed Forces of the United States. Specifically, the H.3147 bill that was passed by the House of Representatives in April of 2015 stipulates that beginning January 1, 2016 military retirement benefits accrued by individuals in South Carolina will transition to a tax-exempt status over a three-year period. Retirement benefits will be subject to a 33.3 percent deduction in 2016, a 66.7 percent deduction in 2017, and a 100 percent deduction in each subsequent year.

Through a detailed examination of the total number of military retirees in South Carolina, their associated income profiles, and the increase in in-state expenditures that will likely result from the additional spending activity of retirees due to the tax exemption, this analysis finds that during the first three years of implementation, the total annual loss to state tax revenue that will result from this tax deduction will increase from approximately \$8.8 million in Year 1 to \$30.7 million by Year 3. This will be offset by gains in tax revenue resulting from additional economic activity that occurs as retirees spend their additional income in the local economy. These gains are projected to generate \$413,993 in new tax revenue in Year 1, which will increase to \$1.4 million by Year 3.

To the extent that the new tax deduction attracts additional military retirees to South Carolina, this would also generate additional in-state expenditures and thus increase the gains to state tax revenue further. Specifically, ***under the assumption of an annual military retiree in-migration rate of five percent beginning in 2017 as a result of the new legislation, the annual gains to state tax revenue from new spending activity will completely offset the annual loss in state tax revenue from the tax exemption itself by the year 2024.*** Figure 1 (next page) displays the net gains in state tax revenue for both zero percent and five percent net in-migration scenarios.

Figure 1 – Estimated Impact of Proposed Military Tax Exemption to S.C. State Tax Revenue

Year	Total Annual Taxable Military Retirement Payments	Loss to State Tax Revenue from Deduction	Gain to State Tax Revenue from Retiree Expenditures (Zero Net In-Migration)	Gain to State Tax Revenue from Retiree Expenditures (5% Annual Net In-Migration)
2015 (Actual)	\$1,363,269,866	N/A	N/A	N/A
2016 (Projected)	\$1,392,390,000	\$8,789,650	\$413,993	\$413,993
2017 (Projected)	\$1,422,409,000	\$17,989,280	\$847,295	\$4,197,068
2018 (Projected)	\$1,453,359,000	\$30,690,990	\$1,445,546	\$8,462,000
2019 (Projected)	\$1,485,273,109	\$31,364,929	\$1,477,288	\$12,504,160
2020 (Projected)	\$1,518,185,069	\$32,059,940	\$1,510,023	\$16,920,124
2021 (Projected)	\$1,552,129,958	\$32,776,764	\$1,543,786	\$21,741,438
2022 (Projected)	\$1,587,144,243	\$33,516,171	\$1,578,612	\$27,002,289
2023 (Projected)	\$1,623,265,838	\$34,278,960	\$1,614,539	\$32,739,736
2024 (Projected)	\$1,660,534,173	\$35,065,966	\$1,651,607	\$38,787,890

Methodology

All data on South Carolina military retirees and their associated income levels were provided by the Defense Manpower Data Center (DMDC). Estimates were provided detailing the total monthly taxable income of all military retirees by age. Figure 2 displays a summary of these estimates.

Figure 2 – Breakdown of Military Retirees and Associated Taxable Income (2015)

Category	Total Number of Retirees	Total Monthly Taxable Income
Active Guard/Reserve Retirees	2,664	\$7,718,170
Non-Disabled Retirees (Includes only Active Component)	37,074	\$88,909,891
Reserve Retirees	13,460	\$16,977,761
Total	53,198	\$113,605,822

On an annual basis for 2015, the total taxable income of military retirees who would benefit from the proposed legislation sums to approximately \$1.3 billion (\$113.6 million per month). This value must then be adjusted to account for additional tax deductions under current law. Depending on a retiree’s age, South Carolina law allows taxpayers under the age of 65 to deduct retirement income of up to \$3,000 per year. Taxpayers 65 and older may deduct retirement income of up to \$15,000 per year. Making these adjustments reduces the total taxable income of military retirees to approximately \$1.0 billion annually.

The next step of this analysis is to determine the total tax revenue generated for the state of South Carolina from these dollars. According to the South Carolina Revenue and Fiscal Affairs Office (SCRFA), the total tax revenue generated from military retirement payments in 2015 was \$25.7 million. This figure was obtained from a fiscal impact analysis conducted by the SCRFA and described in a letter dated

February 25, 2016 to William L. Bethea, Jr. of the South Carolina Military Base Task Force. The letter was prepared by the Executive Director of the SCRFA – Frank Rainwater.

Projections for future annual growth in military retirement payments and the associated tax revenue were also obtained from this same SCRFA analysis.¹ Over the next nine years, total annual military retirement payments will increase – and it is these projected figures that are used to determine the dollar value of the future tax exemption highlighted in Figure 1.

During 2016, military retirement payments are projected to total approximately \$1.39 billion. The SCRFA estimates that this will generate \$26.3 million in gross tax revenue. The year 2016 represents the first of the three-year phase-in, meaning that approximately 33.3 percent of this tax revenue will be credited back to the military retirees. This represents \$8.8 million worth of new income for military retirees.

Much of this new household income for military retirees is likely to be spent in the local economy. Through the use of a highly customized regional input-output model for the state of South Carolina, local consumer spending patterns can be determined. This allows the percentage of new income that is likely to be spent within the state (as opposed to being either saved or spent outside of South Carolina) to be estimated.

This initial local spending on the part of military retirees also leads to additional rounds of local spending activity, known more generally as economic multiplier effects. When military retirees experience an increase in their incomes, they spend part of this additional income on goods and services in the local economy such as food, entertainment, and housing. Each of these industries then experiences an increase in demand as well. For example, upon experiencing an increase in its customer base, a restaurant will have to purchase additional inputs from its suppliers. These suppliers, in turn, will have to purchase additional inputs from their vendors, and so on. Thus, the initial round of spending by the military retirees leads to additional rounds of spending in the local economy, thereby generating a higher total volume of economic activity than what might otherwise be expected.

Once these multiplier effects are calculated and the total increase in economic activity resulting from new spending activity stimulated by the tax exemption is estimated, subsequent increases in tax revenue resulting from this new economic activity can be determined.² Every additional dollar that is generated in economic activity (i.e., nominal gross state product) within South Carolina also generates new

¹ Specific projections were provided by the SCRFA through 2018. Projections in subsequent years were made by the Division of Research, which were based on the assumption that the annual increase in the growth rate of military retirement payments and associated tax revenue would continue at the same pace.

² All economic multiplier effects were generated using the *IMPLAN* input-output modeling software.

state tax revenue. This relationship can be quantified statistically by evaluating historical trends between gross state product and the South Carolina general funds revenue.³ ***Thus, the new spending activity on the part of military retirees will lead to an increase in state tax revenue that will partially offset the loss in state tax revenue from the tax exemption itself. In a scenario in which this tax exemption leads to a net in-migration of military retirees of five percent per year, the increase in tax revenue would completely offset the loss in annual state tax revenue by the year 2024.*** The projected tax revenue that will likely be generated from this new spending activity on the part of the military retirees in both zero and five percent in-migration scenarios is displayed in the two right-hand columns of Figure 1.

³ The historical relationship between South Carolina nominal gross state product and the South Carolina general funds revenue (as measured and tracked by the SCRFA) was estimated by the Division of Research using industry-standard time-series regression techniques.