MINNESOTA CENTER for Fiscal Excellence

The Renewed Push to Exempt Social Security

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The state's huge surplus has propelled a full exemption of social security income to the top of many tax relief wish lists. The numbers may look kindlier on the idea but it remains far better politics than tax policy.

With the legislature's current makeup, the odds are long that large amounts of broad based "permanent" tax relief will come out of this legislative session. However, chances seem very good that a lot of targeted relief will be enacted through new or expanded tax expenditures having lives extending well beyond the current biennium. At the top of the "most likely" list is state income tax treatment of Social Security income. In 2017 and 2019, lawmakers enacted subtractions of social security income and related adjustments to expand the scope of relief to senior taxpayers and non-seniors receiving disability benefits. For many lawmakers, this year's surplus has created the window of opportunity go beyond more incrementalism and half measures. As of this writing seven bills have been introduced, including one co-authored by the DFL Vice Chair of the House Tax Committee calling for an unlimited full subtraction of this income.

As is often pointed out, Minnesota is one of only 12 states that does not fully exempt social security income from state taxation. Does this fact justify it being a top priority for state tax relief? If so, why? And how does this proposal itself stand up to tests of good tax policy? From the standpoint of fiscal responsibility, there is a lot at stake, especially in combination with additional tax relief proposals. Unlike most forms of targeted relief, the potential implications for the General Fund here are significant, starting at well over $1 billion dollars per biennium and going up as the ranks of the 65 and over demographic swell in years to come. It's worth looking at the primary issues and arguments in more detail.

The Good Tax Policy Problem

Public opinion research on taxation consistently finds "fairness" to be the most important feature in a tax system. Ability to pay is the usual concern, but a no less important (and generally overlooked) tax fairness concept is treating income equals equally, or "horizontal equity." This tax principle dictates that taxpayers with the same incomes, regardless of the source of the income, should pay the same amount of tax.

The state's existing social security income subtractions purposely depart from this ideal for a good policy reason: a lot of social security benefits are quite modest, and their recipients may not have the option or ability to obtain extra income in retirement. According to Department of Revenue estimates, only about half of Minnesota households with social security income have taxable social security income.
But even our current comparatively less preferential treatment of this income introduces a notable degree of inequality by treating similarly situated taxpayers differently based solely on their sources of income. It's an obvious issue in thinking about wage earners versus retirees, but significant differences in tax obligations can also exist among social security beneficiary households having the exact same income. Plugging some numbers into House Research's handy social security modeling tool[1] highlights

the issue. For example, a married filing jointly (MFJ) senior household receiving the average state social security benefit of $32,600 supplemented with $27,000 of non-Social security income ($59,600 total) pays no state income tax under current law. Simply flipping those income shares around ($27,000 in social security benefits supplemented by $32,600 in other income) and the household now has a $1,600 state income tax bill.

Fully exempting all social security income would eliminate the horizontal equity problems among social security recipients but greatly exacerbate the problem among all state income taxpayers. A couple additional model results illustrate the potential:

- A retired "lifetime higher earning" senior MFJ household receiving 150% of the state's average social security benefit of $48,900 could have $27,400 in additional taxable income (for a total of $76,300 which is more than the state's median household income of $74,593) before incurring a single dollar of state income tax liability.

- Each year of social security deferral after full retirement age increases benefits by 8% until the age of 70. It is possible for "high dual earning" households having the wherewithal to delay claiming realize $70,000 or more in social security benefits. That couple would pay no state income taxes on a level of social security income over 90% the median family household income in Minnesota. If a household did receive $70,000 in benefits and supplemented their government benefits to declare $100,000 of total income, their total state income tax obligation would be $139.

Making the horizontal equity issue even more relevant is that over the past several decades, the economic welfare of seniors has improved far more than other age demographics. Since 1979, both the median and average incomes of households headed by someone past 65 have climbed faster than the incomes of households headed by people in younger age groups. The difference is not small. Census statistics show that the average real income of elderly households climbed 82 percent between 1979 and 2017 while the average income of households headed by someone younger than 65 increased just 37 percent.[2]

All this points to another, more subjective, fairness-related matter certain to receive a lot of legislator scrutiny. Social security is a near-universal benefit, but the tax relief moving from a partial subtraction to a full exemption is heavily skewed toward Minnesota's higher income retirees. According to a 2019 projection by the Department of Revenue's Tax Research Division for tax year 2021, the estimated amount of taxable social security income in the state's top population decile (households with incomes of $185,600 and above) was $1.52 billion. That's more than the $1.42 billion that exists in the bottom seven population deciles combined (households having incomes below $96,100).[3] Some are sure to question why state tax relief priorities should focus on higher income retirees – especially if rate reductions are also in play.

Keeping the Seniors Home

Many argue the justification resides in the need to keep these individuals and their economic activity, charitable endeavors, and volunteer work here in Minnesota. There is no question that Minnesota is a high-income tax state relative to the rest of the country for upper-middle and high income seniors.[4] According to our latest individual income tax comparison study, Minnesota state income tax burden is either 2nd or 3rd highest in the nation for married joint senior filers with incomes from $75,000 to $250,000 ($250,000 is our highest modeled senior profile).[5] Actual Minnesota tax burdens for these filers range from $1,048 - $4,093 above the average of all states having individual income tax (obviously even more in comparison to states without an income tax.) The same rankings hold for our senior single filer cohorts, although the tax burden differential is a little less.

Taxes, seniors, and mobility is a complicated relationship. Seniors, of course, move for a lot of different reasons besides taxes. Even among seniors whose moves are solely motivated by lower taxes, all forms of taxation will likely be taken into consideration, not just one part of the system. For example, the influential retirement resource Kiplinger ranks Texas 10th in the nation in ***least*** friendly states for retirees despite having no income tax because of its high sales and property taxes.[6] (Interestingly, Minnesota did not make this top ten least-friendly list but Iowa and Wisconsin — both of which exempt social security income — did.)

Table 1 summarizes the last 5 years of Minnesota taxpayer migration among filers 65 years and older by income cohort. This reporting comes with several caveats and is far from perfect. For example, the IRS uses return addresses in assembling this data, not the actual residence of the taxpayer. Therefore, migration findings could be affected by any filer whose return address isn't their residential address (out of state tax preparer, using a P.O. Box, business address if they have pass-through income, etc.). Plus, various timing issues regarding income, taxpayer movement and filing are another potential complication. Nevertheless, it is the best proxy available to us to assess filer migration trends.

Table 1: Minnesota 65+ Tax Filer Migration
As a Percentage of Total Senior Filers at Selected Income Level

Filer Income	2014-2015		2015-2016		2016-2017		2017-2018		2018-2019	
	Out	In	Out	In	Out	In	Out	In	Out	In
$1 under $10,000	0.8%	0.9%	1.1%	1.0%	1.6%	1.5%	1.3%	1.2%	1.4%	1.1%
$10,000 under $25,000	0.8%	0.8%	1.1%	1.1%	1.6%	1.6%	1.3%	1.3%	1.3%	1.2%
$25,000 under $50,000	0.7%	0.7%	1.1%	0.9%	1.5%	1.4%	1.2%	1.2%	1.2%	1.0%
$50,000 under $75,000	0.8%	0.6%	1.0%	0.8%	1.6%	1.4%	1.2%	1.1%	1.2%	1.1%
$75,000 under $100,000	0.9%	0.5%	0.9%	0.8%	1.5%	1.4%	1.2%	1.1%	1.2%	1.0%
$100,000 under $200,000	1.1%	0.7%	1.3%	0.9%	1.7%	1.5%	1.5%	1.2%	1.4%	1.1%
$200,000 or more	1.6%	1.0%	2.0%	1.2%	2.6%	1.7%	2.2%	1.4%	2.2%	1.5%

Source: IRS Statistics of Income Gross Migration Files, 2014-2019

As the table shows, while the state appears in more or less in migration equilibrium for senior filers at and below the state's senior median household income level of just over $50,000, both net outmigration and the relative amount of outmigration increases at higher income levels. Not surprisingly, the $200,000 and over income cohort exhibit the largest percentages of Minnesota out migration on both a net and relative to total cohort population basis.

A key question with respect to senior migration is to what extent exempting social security income would actually influence their decision-making. Affluent seniors receive much smaller proportions of their income from social security benefits. A study examining how income changes in transitioning from work to retirement found the top 40% of senior income earners received one-third or less of their income from social security – the top 5% less than 15%.[7] This relative share may, in fact, be significantly overstated. A 2017 research study by U.S. Census Bureau linking survey responses with administrative records from the IRS and other agencies found that the median household income of seniors aged 65 and over was 30% higher than what the Census reported, "mainly attributable to underreporting of retirement income from defined benefit pensions and retirement account withdrawals."[8]
For higher income seniors, decision-making based exclusively on income taxes (rather than all aspects of the Minnesota tax system) is far more influenced by Minnesota's tax rates and brackets than the amount of social security income exposed to taxation. Whether an exemption of what is often a relatively small fraction of their income could make an appreciable dent in the calculus, or "tip the scales" in favor of staying in the state seems quite unlikely.

The Fallacy of "Double Taxation"

An argument heard in support of a full exemption is that taxing social security is double taxation -- taxed once when taken from the paycheck and again when the benefit is received later in life. It's a compelling political pitch but factually incorrect. The federal government's treatment of this income goes back to the recommendations of the National Commission on Social Security Reform appointed by President Reagan, and was designed to address this very issue.

Social security is responsibly treated as an earned benefit by the federal government and therefore its taxation is appropriately modeled on the taxation of private pensions – paying income tax to the extent that benefits exceed contributions. And for most social security recipients, the benefits far exceed their lifetime contributions.

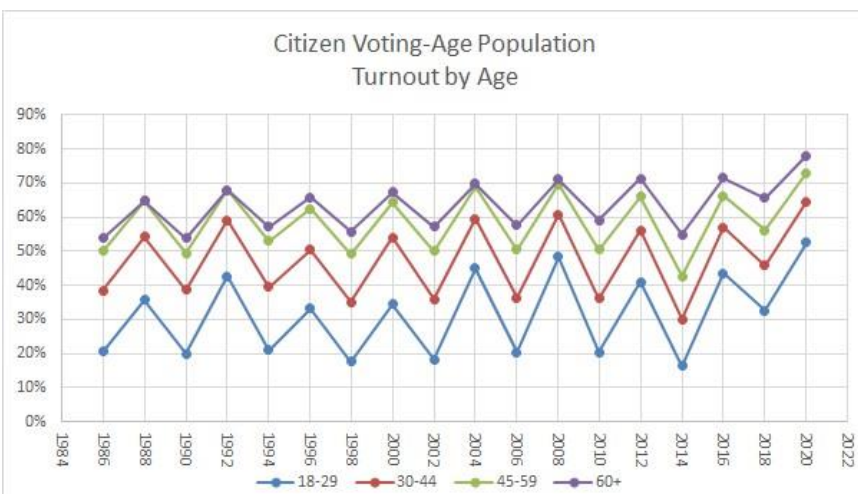
In 1993, the Social Security Administration's Office of the Actuary estimated that, if pension tax rules were applied to social security, the ratio of total employee social security payroll taxes to expected benefits for current recipients would be approximately 4% or 5%. The actuaries adjusted the percentage upward to 15% to accommodate specific worker demographics with the highest ratio of taxes to benefits paid. In other words, the current "85% taxable cap" established by the federal government on social security income ensures no beneficiary pays for more than 15% of his or her own benefits through withholding. In reality, social security is not double taxation but a more favorable tax treatment for the vast majority of workers than even private pension income receives.

The Strongest Argument is Political

"Under no theory of taxation should a person who turns 62 (or whatever age we pick) magically be exempt from taxation. Let's face it, states offer tax relief to old folks because those folks vote more than anyone else."

David Brunori, Tax author and former Deputy Publisher,
Tax Analysts

If there is wisdom in how the majority of states treat social security income, it is political wisdom reflected in the accompanying chart. Fully exempting social security is a way for lawmakers to gain favor with one of the most politically engaged demographic groups, which also happens to be one of the wealthiest. Or as a U.S. Census Bureau spokesman once candidly remarked, "They are worth more, dollar-wise, than young people."[9]



Source: United States Election Project:
http://www.electproject.org/home/voter-turnout/demographics

None of this is a dismissal of policy actions addressing the economic welfare of senior households. Further adjustments to the current subtraction and related modifications deserve to be considered. And other targeting efforts like enhancements to the senior property tax deferral program merit consideration.

Our opposition to this idea is not an endorsement of Minnesota's heavy income tax burden. It is based on a belief that once the total cost has been determined, the burden should be fairly shared. Eliminating taxation on all social security income would be a major step in the opposite direction. Full exemption will cause other taxpayers to shoulder higher burdens even though they have, in many cases, lower incomes.

ENDNOTES

[1] Found at www.house.leg.state.mn.us/hrd/issinfo/sstaxes.aspx?src=20. Estimates are for tax year 2020, assume taxpayers claim the standard deduction, and are at full retirement age. Estimates also assume taxpayers did not have nontaxable income or above-the-line deductions reducing FAGI.

[2] "Despite Scary Headlines, America's Elderly Continue to Prosper" Brookings Institute, August 15, 2019

[3] "Taxable and Nontaxable Social Security Income, Tax Year 2021: Projections from the 2019 Minnesota Tax Incidence Study. MN DOR Memo, April 25, 2019

[4] According to the State Demographer, the median household income for households with a householder age 65+ is $50,886.

[5] *Comparison of Individual Income Tax Burdens by State*, MCFE, May 2021

[6] "10 Least Tax-Friendly States for Retirees" *Kiplinger* on-line, February 18, 2022

[7] "Using Panel Tax Data to Examine the Transition to Retirement" Brady, Bass, Holland, Pierce, SSRN.#2928375 March 6, 2017

[8] "Do Older Americans Have More Income Than We Think?" Bee and Mitchell, U.S. Census Bureau, SESHD Working Paper #2017-39, July 2017

[9] "States Try More Tax Breaks for Seniors" Pew Stateline, April 27, 2015