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To:

The Honorable Henry McMaster
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Subject: Policy analysis of income tax exemptions for military retirees in South Carolina

Executive Summary

The goal of state income tax exemptions for military retirees is to satisfy a value judgment and to attract military retirees to the Palmetto State. This memorandum explores how efficacious and efficient income tax exemptions are in attracting military retirees. Securing gainful employment is a greater motivator for migration. Because the policy does not exclude veteran retirees already living in the state, the policy is an inefficient use of resources misaligning with its designed purpose. A better policy would be to continue taxing military retirement income and earmark collected revenue to fund the State Division of Veterans' Affairs and create streamlined veteran employment opportunities. This policy will more efficiently attract military retirees while satisfying the benefits and ability-to-pay principles of fair taxation.

The Policy Theory of Income Tax Exemptions in State Government

There are currently over twenty million veterans in the United States, though the overall population of veterans is decliningⁱ. Military retirees comprise only about twenty percent of the total populationⁱⁱ. As veterans become increasingly scarce, competition between states to attract military retirees is growing. The primary tool used by states to attract military retirees is retirement income tax exemptions. The policy theory is that the income exemption will attract military retirees—who will then secure senior employment, buy property, start businesses, and pay more taxes elsewhere. According to Minnesota State legislator, Rep. Bob Dettmer, the policy move is a "no brainer."ⁱⁱⁱ However, some tax experts are not as convinced—claiming that veteran tax exemptions are unfair and more of a political move than good fiscal policy.^{iv}

Military Retiree Income Tax Exemptions in S.C.

South Carolina's income tax system closely resembles the federal governments. The rates vary from three to seven percent across five marginal tax brackets^v. South Carolina's Governor, Henry McMaster, enacted a full-retirement income tax exemption for military retirees in 2020, that cost S.C. taxpayers a total of \$18.5 million in lost income tax revenue^{vi}. While not set in statute, Governor McMaster routinely includes full veteran income exemptions in his executive budget. However, the State does offer two partial retirement income tax exemptions. Military retirees who are employed and under the age of 65 can claim an exemption worth \$14,600^{vii}. Retirees age 65

and over can exempt \$27,000 of retirement pay and need not be employed^{viii}. The general assembly is currently considering passing legislation to exempt retirement income entirely.

Migration Motivators for Veterans

According to New York State Veteran Service Director, Col. Jim McDonough, veterans generally pursue one of three migration patterns after leaving the service. These trends are known colloquially in the veteran community as "the rule of thirds." The rule states that one-third of veterans will return to their home of record, the second third will stay close to the military installation where they exit the service, and the final third will migrate to pursue employment^{ix}. An analysis conducted by the Army found similar trends^x. Military retirees, older veterans, and non-white veterans are the most likely to relocate^{xi}. However, sufficient evidence does not yet exist to prove a causal relationship between changes in state tax policy and military retiree migration^{xii}. Local cost of living, proximity to military installations, employment opportunities, and superior government services account for a more significant percentage of the variation in retiree migration^{xiii}. That said, South Carolina expects to see a significant influx of migrating veterans in the coming years^{xiv}.

The Role of State Veterans' Affairs Agencies

In May of 2019, the Governor established the South Carolina Department of Veterans Affairs as a cabinet-level agency^{xv}. In 2020, South Carolina allocated \$2.6 million to the newly founded department^{xvi}. The state Veterans Affairs Department primarily assists veterans in accessing benefits and manages the states' veteran cemeteries and nursing homes^{xvii}. However, a growing body of literature reveals that state agencies will face a paradigm shift from the traditional service delivery model and play a more involved role in the national veteran strategy. According to the Institute for Veterans and Military Families, national trends reveal state agencies are functioning more as service coordination centers^{xviii}. In this way, the agency functions as a bridge between the federal and State government while also leveraging local non-profits and community support^{xix}. The report further underscored that state veterans' can be extremely effective and innovative, provided they have, "adequate, predictable, and diversified funding"^{xx}

Analysis

Applying the rule of thirds equally to retirees as the general veteran population, retirees will move to South Carolina regardless of tax benefits; This is primarily due to the number of military installations and the large volume of veterans that enlist from South Carolina. Two of the eight military bases in South Carolina—Fort Jackson and Paris Island—are the largest training posts in the military^{xxi}. Additionally, South Carolina enlists more recruits per-capita than any other state^{xxii}. Therefore, the rule of thirds states that a high number of military retirees would already move to South Carolina; This could explain why Columbia expects to see the veteran population increase substantially over the next four years^{xxiii}.

Table 1: Top ten states with the highest number of military retirees

State	Military Retirees	Proportion of Population	Offers Exemption
Texas	201,715	10%	n/a
Florida	192,784	9%	n/a
California	161,263	8%	No
Virginia	154,427	7%	No
Georgia	94,615	5%	Partial
North Carolina	92,553	4%	Yes
Washington	72,609	4%	n/a
Alabama	59,868	3%	Yes
South Carolina	58,552	3%	Partial

Data Source: Department of Defense

As we can see from Table 1 above, military retirement exemptions may play a role in influencing migration habits, but that role appears to be minimal. Additionally, policy benefits are not targeted to retirees migrating to the state. Thus, if the number of military retirees increased by 5% (~3,000 retirees), the state cannot exclude the current 58,000 retirees already residing in South Carolina. New Mexico faced a similar problem when evaluating a mirrored policy. To make the exemption worthwhile, the number of military retirees would have to increase by a minimum of 8.34% to account for retirees already living in the state—a 6.82 percentage-point jump from the average 1.52% increase^{xxiv}. According to Clemson University’s Economic Analysis laboratory, the state’s revenue streams will experience net benefits after the policy’s implementation^{xxv}. However, the researchers are unable to attribute the benefits gained to the tax exemption specifically.

The second goal of military retirement income tax exemptions is to satisfy a values judgment that retirees should receive tax relief. However, there is no evidence to suggest that retirees are financially burdened. The states’ average income tax burden per capita is a modest \$780^{xxvi}. On average, retirees receive \$27,000 annually in benefits, which is about equal to the median state income and excludes earned income^{xxvii}. Lastly, South Carolina’s veteran population on average earn 47% more than non-veterans^{xxviii}. Thus, providing retirees a full tax exemption is a regressive policy primarily benefiting citizens with a higher ability-to-pay.

Recommendations

To better meet policy objectives of attracting and assisting military retirees to South Carolina, lawmakers should:

1. Abort fully implementing a retirement income tax exemption for military retirees and maintain the partial tax exemption.
2. Earmark collected revenue to fund the state Division of Veterans’ Affairs and streamlined employment pathways for military retirees.

Justification

Tax policy may influence retiree migration habits, but a lack of peer-reviewed research leaves the extent of that role largely unknown. However, the importance veterans place on securing gainful employment, and their subsequent struggle in doing so, is grounded in fact. Two of the top five issues cited by transitioning service members are finding a job and applying military skills to civilian work^{xxix}. Additionally, approximately one-third of transitioning veterans will migrate to new areas in pursuit of employment. Therefore, investing in the creation of veteran employment opportunities is a more appropriate policy prescription to attract military retirees.

Earmarking revenue collected from military retirement to fund the State Department of Veterans' Affairs would allow the state to provide a host of tailored services—from employment to assistance in securing housing. A better funded state veterans' affairs agency would drastically aid in meeting the needs and wants of all veterans living and transitioning to South Carolina. The newly created state agency is on the right track to playing a pivotal role in veterans' transition, but the state must invest additional resources into this mission. This policy would provide lawmakers with the fiscal flexibility to continue providing retirees with a partial tax exemption, while drastically improving services offered by the state. Innovative policies such as these would provide a competitive advantage over states like Florida that do not levy an income tax. If enacted, this policy would satisfy the benefits principle of fair taxation, which states that those benefiting from government services should pay for those services.

These recommendations satisfy both the benefits and vertical equity principles of fairness. Recall that the theory of exempting veteran retirement benefits is that military retirees are more senior in career experience and will provide benefits to the State in other revenue categories. However, this theory violates the fairness principle of vertical equity that those with higher incomes should pay more. As such, taxing veteran retirement supports a progressive tax system.

Conclusion

The military retiree population is declining, and the role of state veterans' affairs agencies is changing to support the needs of veterans. As military retirees and fiscal resources become increasingly scarce, states must adopt new and innovative policies to attract retirees. There is no evidence that South Carolina's military retirement exemptions attract retirees, or that military retirees are disproportionately financially burdened. However, there is ample research underscoring the importance veterans place on securing gainful employment. To attract retirees and preserve resources, the state should continue taxing military retirement benefits and earmark collected revenue to fund the state Department of Veterans' Affairs and create streamlined veteran employment opportunities. Doing so will provide essential benefits to all veterans while satisfying the benefits and vertical equity principles of just tax policy.

Due to changing demographics, the needs and wants of veterans transitioning out of the service are becoming challenging to triangulate. The growing complexity has increased the demand for additional and tailored services^{xxx}.

Annotated Bibliography

ⁱ U.S. Department of Veterans' Affairs. (2016). *Veteran Population Projections 2017-2037*. Washington, D.C.: National Center for Veterans' Analysis and Statistics.

The National Center for Veteran Analysis publishes regular reports and collects critical data necessary to evaluate veterans' policy. Their reports are highly regarded and regularly cited by advocates.

ⁱⁱ "Military Retirement System .Pdf." Defense Manpower Data Center, May 2019. https://media.defense.gov/2019/May/14/2002131753/-1/-1/0/MRS_STATRPT_2018%20V5.PDF.

This source report is published by the Department of Defense. It

ⁱⁱⁱ Povich, E. S. (2015 , August 10). States Compete for Military Retirees. *Pew Research Center*.

The Pew Research Center is a think-tank that published reputable research on a host of issues. This article summarizes the fight between states to attract military retirees.

^{iv} See note above.

^v Scarboro, Morgan. 2018. *State Individual Income Tax Rates and Brackets for 2018*. Washington, D.C. : The Tax Foundation.

^{vi} McMaster, Henry. "2021 Executive Budget: State of South Carolina," January 13, 2020. <https://governor.sc.gov/sites/default/files/Documents/Executive-Budget/FY21%20Executive%20Budget.pdf>. 15 February 2020

This is the executive budget of Governor McMaster. In the executive summary, the governor outlines his legislative priorities.

^{vii} S.C. Department of Revenue . 2019. *Tax Tips for Veterans and Military Personnel* . November 7. <https://dor.sc.gov/resources-site/media-site/Pages/Tax-tips-for-veterans-and-military-personnel.aspx>.

^{viii} Ibid

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McDonough, C. (2019 , October 17). *New York State General Assembly Hearing* . Retrieved from Delivery of Veterans' Services and Programs in New York State : https://nystateassembly.granicus.com/MediaPlayer.php?view_id=8&clip_id=5217#

This is the actual testimony of the Jim McDonough, Director of the State Division of Veterans Affairs, to the New York General Assembly. The hearing was an attempt by New York lawmakers to understand the most pressing issues affecting veterans.

^x Prestigiaco, J. (2018). *Review and Analysis of the state of Transitioning Soldiers*. U.S. Army Soldier for Life.

^{xi} Ibid, pp. 52

^{xii} Pace, Ph.D., Levi. 2017. *Analysis of Military Retirees in Utah: Impacts, Demographics and Tax Policy*. University of Utah Policy Institute.

^{xiii} Ibid, pp. 12

^{xiv} RAND Health . (2015). Current and Future Demographics of the Veteran Population . In *Current and Projected Characteristics and Unique Health Care Needs of the Patient Population Served by the Department of Veterans Affairs* (pp. 50-56). Washington, D.C. : RAND Corporation.

The RAND corporation is a think-tank that publishes a host of research regarding veterans' issues. This source is a section from their book outlining the needs of patients served by the VA, and underscores how the demographic is shifting.

^{xv} S.C. Office of the Governor. 2019. "Gov. Henry McMaster Announces Rep. Bobby Cox as South Carolina's First Secretary of Veterans' Affairs." Press release, Columbia.

^{xvi} See note five above, pp 65

^{xvii} South Carolina Department of Veterans' Affairs. 2020. *Our Mission: Homepage*. <http://va.sc.gov/>.

^{xviii} Huitink, Z., Armstrong, N., Birnbaum, N., & Van Slyke, R. (2019). *Innovation in State-Level Veterans Services: A Comprehensive Review, Case Highlights, and an Agenda for Enhanced State Impact*. Syracuse, New York: Institute for Veterans and Military Families, Syracuse University.

The Institute for Veterans and Military Families is the premier institution in veterans academic research—publishing research in all aspects of veteran life. They have published extensive peer-reviewed research in the actions of state veterans' affairs agencies.

^{xix} Ibid, iii

^{xx} Ibid, pp. 111

^{xxi}

Military One Source . (2020, February 22). *Military Installations* . Retrieved from South Carolina Installations : <https://installations.militaryonesource.mil/state/SC/state-installations>

Military One Source is the principle resource used by the military members and their families to research different areas as the military moves service members from duty station to duty station. They have a host of resources for the public in determining what resources are available to veterans, military members, and their families.

^{xxii} Office of the Undersecretary of Defense. (2017). *Population Representation in the Military Services*. Department of Defense. pp. 19

Every year the Under Secretary of the Department of Defense publishes the Population Representation in the Military Services Report. The report outlines the DOD's recruiting efforts and the makeup of the current operational force.

^{xxiii} Ibid,

^{xxiv} Popp, Anthony V., and Meghan C. Starbuck. 2009. *The Economic Impact of Exempting Retired Military Service Payments from New Mexico Personal Income Tax*. New Mexico : Arrowhead Center, Office of Policy Analysis, New Mexico State University.

^{xxv} Carey, Robert T. 2019 . *The Projected Economic & Fiscal Impact of Exempting Military Pension Income from South Carolina Income Tax*. :Clemson University: Regional Economic Analysis Laboratory.

^{xxvi} The Tax Foundation. 2020. *Taxes in South Carolina* . <https://taxfoundation.org/state/south-carolina/>.

^{xxvii} Congressional Budget Office. 2019 . "Military Retirement: CBO's January 2019 Baseline." Washington, D.C.

^{xxviii} See note 24 above, pp. 2

^{xxix} C. Zoli, R. Maury, & D. Fay, *Missing Perspectives: Servicemembers' Transition from Service to Civilian Life — Data-Driven Research to Enact the Promise of the Post-9/11 GI Bill* (Institute for Veterans & Military Families, Syracuse University, November 2015). pp. ii

^{xxx} H.R.5515, John S. McCain National Defense Authorization Act for Fiscal Year 2019. Sec. 552

In the National Defense Authorization Act of 2019, the DOD made large changes to the transition services provided to veterans by creating the "Pathways Transition Assistance Tap." The move was an effort to provide more tailored services to all veterans leaving the service.