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Should Illinois Tax Retirement Income?

Most States Provide Better-Targeted Tax Breaks for Middle- and Low-Income Seniors; Cost of Illinois Exemption Likely to Explode

Earlier this month, Illinois Senate President John Cullerton suggested that limiting the state's generous income tax break for retirement income "would just be a matter of fairness." Senator Cullerton's suggestion gives Illinois policymakers a welcome opportunity to reflect on the appropriate design of senior-citizen income tax relief in Illinois. This paper summarizes the mechanisms used in Illinois and in other states to reduce senior citizens' income tax liability, and provides a menu of options for reforming the current system.

How Elderly Income Tax Breaks Work in Illinois—And In Other States

Most of the 42 states that currently levy broad-based personal income taxes use federal tax rules as a starting point. Since federal law taxes most pension benefits and taxes a fraction of Social Security benefits for about half of the best-off seniors, states seeking to provide extra income tax breaks for seniors must enact special tax breaks of their own. While virtually every state allows at least a small additional exemption for retirement income, Illinois is currently one of only four states that completely exempt pensions, annuities and Social Security benefits from a broad-based income tax.[1] The Illinois Office of the Comptroller estimates that in fiscal year 2009, this single category of income tax exemptions cost the state almost $1 billion, making this the largest state income tax break in the state's list of "tax expenditures" for that year.[2]

Most other states have chosen more cost-effective approaches to exempting seniors' income:

- Many states allow retirement income exemptions only up to a **capped amount**. The cap on these exclusions varies substantially: Michigan allows an exemption for up to $42,000 of retirement income for each taxpayer, while Iowa exempts $6,000 per taxpayer.
- Other states reduce the cost of these capped exemptions using **income limits**. For example, Virginia gradually phases out its $12,000 retirement deduction for single taxpayers earning over $50,000 (and married taxpayers earning over $75,000).
- Some states take a simpler (and more equitable) approach, giving senior citizens an extra **exemption for income from all sources**. For example, Indiana supplements its $1,000 personal exemption with an extra $1,000 for seniors. (Illinois takes this approach as well, supplementing the basic $2,000 personal exemption with an extra $1,000 per senior.)

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[1] Mississippi and Pennsylvania exempt all retirement income, and legislation enacted in Georgia in 2010 will fully exempt retirement income when the new law fully phases in later in the decade.

[2] *Tax Expenditure Report, Fiscal Year 2009*, State of Illinois Office of the Comptroller. http://www.apps.ioc.state.il.us/ioc-pdf/TaxExpFY09.pdf

Options for Reforming Retirement Income Taxation in Illinois

The Illinois retirement exemption's billion-dollar price tag alone should give lawmakers ample reason to ponder reform alternatives. But even this price tag is misleadingly low in two ways. First, the recent increase in the Illinois income tax rate from 3 to 5 percent means that the cost of the retirement tax break increased substantially as well. Second, the rapidly aging U.S. population means that the cost of senior-citizens tax breaks will grow quickly in the near future. What policy choices await Illinois policymakers seeking to curb the cost of this tax break while providing needed tax relief to fixed-income seniors?

- **Revenue-neutral or revenue-raising reform?** Simply eliminating the retirement income tax break would allow lawmakers to reduce the state income tax rate from 5 percent to 4.55 percent, leaving overall tax collections virtually unchanged, if lawmakers chose to pursue a "revenue-neutral" approach to reform. This approach would result in a net tax cut for 72 percent of Illinois taxpayers, and about 15 percent of Illinois seniors. At the other extreme, simply broadening the base and leaving the rates unchanged would grow income tax revenues by about $1.6 billion in 2011, although this approach could mean substantial tax hikes for virtually all Illinois seniors.
- **Impose income limits, or simply cap the exemption?** The most straightforward approach to reform would be to add a sensible cap to the value of the deduction. A $10,000 per-spouse exemption for retirement income would ensure that seniors would continue to receive an additional tax cut compared to non-elderly families, while sharply reducing the annual cost of the exemption by $690 million. Adding an income limit for eligibility would reduce the cost even further.
- **Retirement income, or all income?** It's hard to make a case for exempting the pension benefits of the wealthiest retirees while providing no similar tax break for seniors who must work full time to make ends meet. Yet that is what Illinois currently does. Allowing an extra senior exemption from all income sources would ensure that low- and middle-income Illinois seniors won't be taxed further into poverty, and would also avoid discriminating against working seniors.
- **Tax relief for seniors, or low-income families more generally?** Part of the rationale for the current retirement exemption is that low-income seniors have less "ability to pay" income taxes and should therefore pay less. But the same argument holds for non-elderly families living below or near the poverty line as well. Tax savings from paring back the retirement exemption could be partially spent expanding the state's relatively paltry low-income exemptions and tax credits.

Conclusion

Senator Cullerton's recent observation that limiting retirement tax breaks could add to the fairness of the income tax is a welcome addition to the long-simmering debate over how to reform the state's tax system. The starting point for tax reform should be evaluating the rationale for each tax break the state currently provides, and the retirement exemption is by far the most expensive tax break allowed under the state's income tax rules. Paring back the retirement exemption could help Illinois policymakers to achieve a number of legitimate objectives, from helping to fund needed public investments to providing across-the-board tax cuts to Illinoisans of all ages. The daunting fiscal policy challenges facing state lawmakers in 2011 could each be made less challenging through sensible base-broadening retirement tax reform.