

Boom(ers) and Bust: Wisconsin’s Aging Population and Tax System

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The average age of Wisconsin’s population, like that of the United States, has grown much older than in the past. That’s a trend that will only accelerate as the baby boom generation begins joining the ranks of retirees.

As the number of elderly people grows, so does the political clout yielded by that demographic group. One possible result, which we are already beginning to see, is an increase in the number of tax breaks for seniors. That means revenue from the fastest-growing part of the population is declining, at the same time that need is growing for programs serving the elderly.

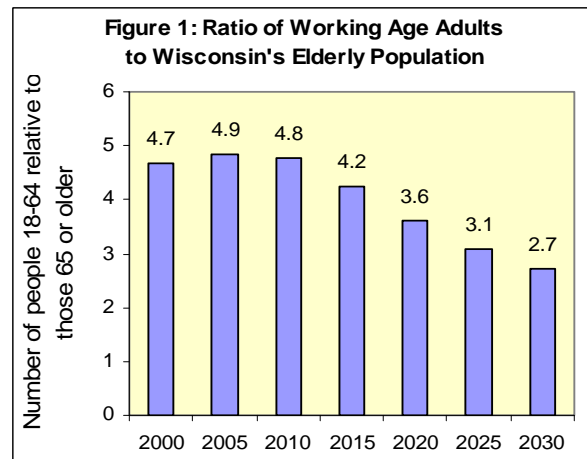
Other structural problems in Wisconsin’s state and local tax system are already causing tax revenue growth to fall behind the increasing cost of maintaining basic government services. A substantial erosion of tax revenue from seniors would compound those problems and make it very difficult for the state to fund the programs needed by the elderly and other Wisconsin residents.

This paper examines some of the issues that may arise in the near future, as the Wisconsin Legislature considers more tax breaks for the elderly and grapples with the challenges of adequately funding state programs and services, such as health care and property tax relief.

Demographic Changes

The baby boom generation begins to retire in the next few years. The result will be a dramatic shift in Wisconsin’s demographic profile. Our analysis of the Department of Administration’s population projections for the next couple of decades reveals the following:

- The number of Wisconsinites age 65 or older is expected to grow by about 617,000 from 2005 to 2030, an increase of almost 86 percent.
- The number of adults ages 18 to 64, who will be paying most of the taxes, will grow just 4 percent over that same period, and is even expected to decrease slightly from 2010 to 2030.
- The portion of the state population age 65 and older will grow from 12.9 percent in 2005 to 20.8 percent in 2030.



Source: WCCF analysis of DOA population projections.

Tax Challenges

The state’s population is not the only thing that is getting older; our tax system is also showing signs of age. While aging is not a negative per se, failing to change with the times can cause problems. The following economic trends are cutting into state revenue because our tax system has failed to adapt:

- The service sector is becoming a larger part of the economy, and – since services are more likely to be tax exempt – that

shift suppresses the growth in sales tax revenue.

- A rapidly growing portion of retail sales are made over the Internet and are escaping sales taxes.
- Corporate profits are a larger share of national income than at almost any other time, but corporations are increasingly adept at using subsidiaries and accounting gimmicks to avoid state taxes on those profits.

An increase in tax breaks for a ballooning segment of the state's population – the elderly – would only compound the problem of a structural budget imbalance caused by the factors noted above.

The State Deficit and New Tax Breaks

Wisconsin policymakers began their deliberations on the 2007-09 biennial budget facing a gap of \$1.6 billion between agency budget requests and the amount of general purpose revenue (GPR) the state expects to collect over the next two years. At least \$600 million of that deficit can be attributed to tax cuts enacted in recent years that take effect in 2007-09.

The historical growth rate in state general fund tax collections has been about 5 percent per year. However, the growth rate in the next biennium is expected to be just 3.2 percent in 2007-08 and 3.5 percent in 2008-09. That slowdown can be attributed in part to the delayed tax cuts taking effect in 2007-09. Two of those new tax breaks are particularly relevant to seniors:

- ***Social Security exemption*** – Late in the process of passing the 2005-07 budget, the legislature added a provision that exempts all Social Security benefits from state income taxes. That tax break will reduce state revenue by about \$100 million per year, starting with tax year 2008. Prior to that change, Social Security benefits were exempt until a taxpayer's income reached \$30,000, but taxes applied beyond that point. The expanded

exemption reduces revenue by about \$146 million in the 2007-09 biennium and \$200 million in the following biennium.

- ***Wisconsin's estate tax*** – Another large tax break that is slated to begin soon is the elimination of the state's estate tax. A change in federal law in the spring of 2001 ended (at least until 2011) the policy of allowing certain state estate taxes to be subtracted from the federal tax. That essentially phased out the estate taxes in the vast majority of states that, like Wisconsin, made their tax contingent upon being able to offset it dollar for dollar against the federal liability. The Wisconsin Legislature responded soon after that by amending the 2001-03 budget bill to decouple the state estate tax from federal law until 2008, thus preserving it through the end of this year.

If the state estate tax ends in 2008, as currently scheduled, that change will reduce state revenue by about \$83 million in the 2007-09 biennium, and by about \$200 million in 2009-11. Wisconsin's estate tax applies to estates worth at least \$675,000, and is owed on only about 2 percent of estates. Given the amount of revenue at stake, extending the estate tax is one of the more straightforward ways the legislature could plug some of the potential holes in the 2007-09 budget.

More Exemptions for Seniors?

Notwithstanding Wisconsin's serious fiscal challenges in 2007-09 and an ongoing structural deficit from phased in tax cuts in future years, it is very possible that a new and even larger tax break for seniors could be added to the budget bill. Legislators in both parties have expressed a desire to exempt all or part of pension income from state taxes.

One of several proposals to create such a tax break is AB 28, which would establish a new tax exemption for a wide range of pension income, including deferred compensation. It would apply to \$2,500 worth of benefits in 2008, and that amount would gradually grow to \$20,000 in 2012 and thereafter.

The Department of Revenue estimates that once the bill is fully phased in it would reduce state tax revenue by somewhere between \$310 and \$415 million per year. That would add to a substantial structural deficit that the state will once again carry forward into the next biennium, thanks in part to other phased-in tax cuts. Nevertheless, AB 28 was recently recommended for passage by the Assembly Ways and Means Committee.

A far less expensive bill that would also assist seniors would increase the personal exemption. Currently, Wisconsin's individual income tax provides a \$700 exemption for each taxpayer, spouse and dependent, and an additional \$250 for a taxpayer or spouse who is 65 or older. Senate Bill 4 would raise the additional amount for seniors to \$300 for those aged 70 to 74, and to \$350 for those 75 or older. It would reduce taxes for the elderly by close to \$1 million per year.

Tax Equity

When policymakers talk about creating or expanding tax breaks for seniors, they often paint a picture of low-income retirees living on a small, fixed income and struggling to pay rising property taxes. All of us can sympathize with people trying to cope with that situation. Yet most of the large new tax breaks don't help low-income seniors who most need the assistance.

Eliminating the estate tax is probably the single most regressive change the state can make in the tax code. The Social Security tax change is better in that respect, but it does far less to help low-income seniors than most people might guess. Taxpayers with adjusted gross incomes of less than \$30,000 account for more than half of all income tax returns filed in Wisconsin, but they will receive only 7.6 percent of the total benefit of the new Social Security tax exemption.

It should also be remembered that nearly three-fifths of all state tax general fund revenue is used for local aids. To the extent that reducing state income taxes cuts into those aid

programs, it may indirectly increase property taxes for many people who will see little or no benefit from the new tax exemptions.

With that in mind, it makes more sense to be careful in targeting any tax relief to be sure that it assists the intended population. One effective way to deliver well-targeted property tax relief is to increase the Homestead tax credit and index it for inflation. That property tax relief program is one of the only parts of the state tax code that is not indexed for inflation. The maximum credit has not been increased since 1991, and is now worth 33 percent less than it was 16 years ago. The Governor's budget would at long last begin to index the formula for calculating the credit, though it does not make up for any of the erosion of the credit over the last 16 years.

If policymakers want to target tax relief specifically to seniors, there are other ways to accomplish that. For example, a bill discussed above, SB 4, would increase the personal exemption by \$50 for income tax filers and spouses who are at least age 70 and by \$100 for those who are 75 or older. That bill, or a variation on that theme, offers a much better way of ensuring that a wide range of seniors receives tax relief – if that is the objective – rather than purporting to help seniors through tax exemptions that disproportionately benefit higher income households and provide little or no relief to most seniors.

Competing Needs

With the number of Wisconsinites who are 65 or older expected to almost double by 2030, the number of people receiving care in nursing homes or in community care will also grow dramatically, which will put tremendous pressure on state spending.

To put the potential fiscal challenges in context, it is worth noting that Wisconsin currently spends more than \$1.7 billion a year in state tax funds for Medicaid. The elderly and people with disabilities comprise just 25 percent of Medicaid enrollees, but they accounted for 71 percent of Medicaid spending

in 2005-06. With that in mind, it is easy to see how growth in the elderly population receiving Medicaid benefits could cause a very significant increase in state spending. We can already see a similar impact on health care spending in the Department of Correction's budget because of the sharp rise in the number of geriatric prisoners.

Aside from the growth in the elderly population, human service programs are also being squeezed by other factors – including long-frozen state funding for local programs, such as Community Aids, and reduced federal support for state and local aid programs. For example, the President's FY 2008 budget proposal would cut grants to Wisconsin for non-entitlement programs by about \$90 million in the coming fiscal year and by roughly \$600 million over the next five years.

(See: *Wisconsin Hit Hard by the President's Proposed Budget*

http://www.wccf.org/pdf/wihithard_prespropdbudget_022207pr.pdf)

An even bigger fiscal problem for Wisconsin in its efforts to serve the elderly is the recent decision of the Bush Administration not to renew the state's waiver for the SeniorCare program, which assists seniors with the cost of prescription drugs. The rejection of the waiver for that very popular and successful program means the loss of more than \$60 million per year in federal funds.

Conclusion

The number of people 65 and over in Wisconsin is expected to grow by 86 percent from 2005 to 2030, yet the number of adults 18 to 64 will be almost unchanged over that period. That trend is likely to significantly increase state spending for health care, while it may also suppress tax collections – especially if the state keeps creating and expanding tax breaks for seniors.

Tax cuts for the elderly (and their heirs) are already having a major impact on the state budget. The full exemption of Social Security benefits from state income next year and the

upcoming elimination of state taxes on estates (also beginning in 2008), will reduce state revenue by about \$229 million in the 2007-09 budget and roughly \$400 million in 2009-2011. The legislature is also considering a new tax break for pension income, which is projected to cost between \$310 million and \$415 million per year when the proposal is fully phased in.

As we look ahead to a time when more than one out of every five people in Wisconsin is 65 or older, policymakers need to consider whether our state can afford to provide blanket tax exemptions to people in that segment of the population, regardless of income level. They need to examine what the demographic trends mean for spending and how those trends will compound the structural problems already cutting into revenue collections.

Policymakers should also carefully consider which taxpayers truly need assistance, and how the state's tax breaks can be better designed to reach those most in need. Options for targeted property tax relief, such as updating and indexing the Homestead Tax Credit, are far less expensive and more effective at delivering tax relief to low-income seniors.

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