Senate Ways and Means Committee
April 15, 2015

Retirement and Age-related State Income Tax Expenditures

Testimony of Jon Honeck, Ph.D.
Director of Public Policy

Good morning, Chairman Peterson, Vice Chair Beagle, and Ranking Member Tavares. I am Jon Honeck, Director of Public Policy for The Center for Community Solutions, a non-profit research and advocacy organization with offices in Cleveland and Columbus. Our mission is to propose non-partisan policy solutions to improve health, social, and economic conditions for all Ohioans. For a number of years we have supported the enactment of legislation that would create a comprehensive framework for sunset review and evaluation of all tax expenditures in the state tax code. We are encouraged to see that the administration's budget proposal includes a review process and that the House of Representatives has several bills that address this issue.

I am here today to discuss our report *Aging Ohio: The Impact of Demographic Change*, which was released in October, 2014, with support from The Cleveland Foundation. It is no secret that Ohio's population is aging. By 2035, it is estimated that nearly one-fourth of Ohio's population will be age 65 or over, up from 14 percent in 2010. The demographic change is unprecedented and will have major implications for our economy and society. *Aging Ohio* estimated the impact of aging on major state tax and benefit systems, specifically the income tax, sales tax, homestead property tax credit, and the Medicaid program. The model assumes the continuation of recent trends in income and a continued shift away from traditional pensions toward 401(k) plans and IRAs. The bottom line is that Ohio's finances will be squeezed by lower tax revenue created by having fewer people in the workforce, worsening trends in retirement income security, and higher spending on long-term care and other programs associated with aging. The aging population will also drive expenses higher in Medicaid.

One of the key components of our income tax estimate was an analysis of tax expenditures related to aging and retirement. Ohio maintains certain credits and deductions intended to lower liability for seniors and retirees. The $50 credit is available to all tax returns filed by seniors age 65 and over. The retirement income credit for pensions and retirement accounts such as 401(k), or Individual Retirement Account distributions is taken by 80 percent of senior returns. We also looked at the social security deduction, which permits taxpayers to deduct social security retirement or disability (SSDI) payments that are partially taxed at the federal level and included in federal adjusted gross income (AGI). Of the 41 states with an income tax, 13 states tax at least some portion of social security benefits.[1] Finally, we also looked at the military retirement deduction and the medical expense deduction. The latter deduction is not age-related but it is claimed by nearly half of senior returns. It is actually comprised of four deductions that are calculated separately but combined into one line on the Ohio return.

Table 1. Major Income Tax Credits for Seniors and Retirees

Credit Type	**Eligibility**	**Credit Amount**	**Estimated Cost FY 2015 (ODT)**
Senior Citizen Tax Credit	Taxpayers 65 years or older. Not dependent on retirement.	$50 per return	$24.5 million
Lump Sum Distribution Senior Credit	Taxpayers 65 years or older who received a qualifying lump sum distribution. Claimed in lieu of the senior citizen credit and disqualifies the filer from taking senior citizen credit in the future.	$50 per return multiplied by expected remaining life years	Below $1 million
Retirement Income Credit	Ohioans who receive retirement income from pensions or retirement accounts. Not dependent on age.	Tiered credit ranging from $25 - $200 per return	$148.7 million
Lump Sum Retirement Credit	Ohioans who receive a lump sum distribution from a retirement account payout that was included in their federal return.	$25-$200 per return multiplied by expected remaining life years	$1.6 million

Table 2. Major Income Tax Deductions for Seniors and Retirees

Deduction	**Eligibility**	**Estimated Cost FY 2015 (ODT)**
Social Security Deduction	Taxpayers can deduct the amount of social security retirement or SSDI payments they receive that were included in their federal return.	$283.3 million
Excess Medical Expense Deductions	Taxpayers can deduct the full amount of:	Total $95.6 million
	• Excess medical care expenses;	$55.7 million
	• Unsubsidized medical care insurance premiums for dental, vision and health;	$28.7 million

[1] These 13 states are: Colorado, Connecticut, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Rhode Island, Utah, Vermont and West Virginia (Source: Retirement Living Information Center).

(Consolidated into one line item on Ohio return; not age-dependent)	• Unsubsidized long-term care insurance premiums; • Accident and health insurance premiums paid for qualifying dependent relatives.	$6.6 million $4.6 million
Uniformed Services Retirement Deduction	Taxpayers retired from service in the armed forces can deduct the full amount of their military pension	$31.3 million

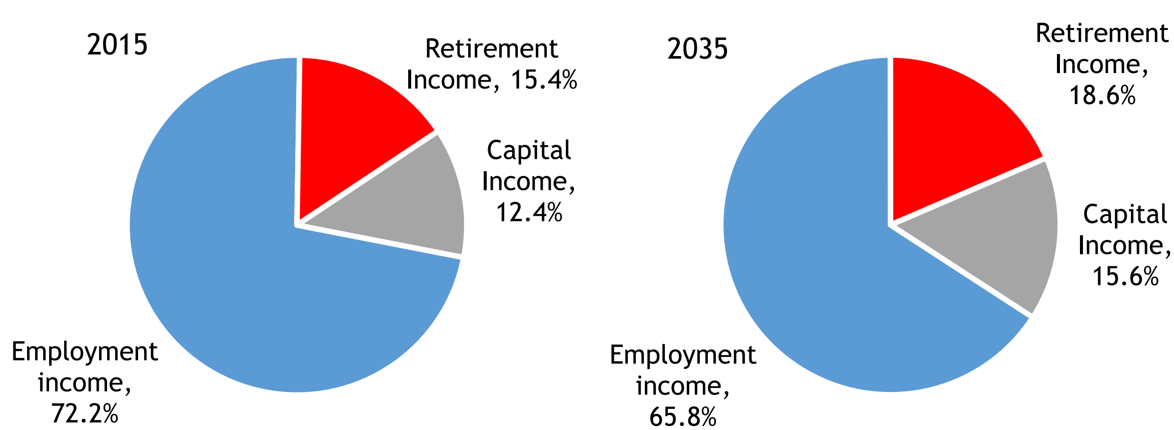
Source: Ohio Department of Taxation, Tax Expenditure Report

Estimates for Income Tax Expenditures

Our income tax model estimates the number of taxpayers within age cohorts and each cohort's receipt of eight kinds of income through 2035. The model estimates that the number of senior tax returns will grow to 1.3 million in 2035, at which point senior households will be 25 percent of all taxpayers. At the end of this 20-year period, the number of taxpayers receiving pensions will be slightly lower than today, and the share receiving retirement account income (e.g., 401(k) and IRAs) will increase from just under half to about two-thirds. Nonetheless, the total amount of retirement account income in AGI will be 35 percent less than pension payments due to lower average distributions from retirement accounts when compared with pension distributions.

The composition of AGI undergoes some significant changes from 2015 to 2035. Employment earnings (including self-employment) decline from more than 72 percent of the total to just under 66 percent. Retirement-related income types (pensions, IRAs, Social Security), which currently receive some form of tax shelter from the state, increase their share from 15.4 percent to 18.6 percent. Capital income (capital gains, ordinary and qualified dividends, interest, partnership income), which is more prevalent at older ages, increases its share by more than three percentage points, from 12.4 percent to 15.6 percent.

Figure 1. Estimated Composition of Federal Adjusted Gross Income (AGI), 2015 vs. 2035



Source: The Center for Community Solutions

Social Security Deduction
The model assumes the continuation of current federal tax law and estimates that the amount of taxable Social Security included in federal AGI, but then deducted on Ohio tax return, will increase by 56 percent in real terms between 2015 and 2035. By 2035, the estimated amount of the deduction would grow to $12.4 billion in real terms. The number of resident returns of all ages claiming the deduction will increase to nearly 1.2 million.

Retirement Income Credit
Our model assumes the continuation of current law that limits the total amount of the retirement credit to $200 per return. Historically, the number of taxpayers claiming the state retirement income credit is just over half of the combined total number of returns with retirement account distributions and pension payments. This means there are many taxpayers who are accessing both a pension and a retirement account in the same tax year and the retirement income credit is applied to both. We estimate that there will be 966,000 taxpayers with pensions and 1.03 million with retirement accounts in 2035 and that the average credit (now at $176) will continue to grow at the current trend rate.

Because the amount of the credit is capped, the total inflation-adjusted value will fall by 29 percent between 2015 and 2035, from $170.1 million to $120.2 million.

Senior Credit
As discussed above, the number of senior citizen filers will grow from 880,000 in 2015 to 1.3 million. With the value of the credit limited to $50 per return, however, inflation erodes its value over time. In real terms, the inflation-adjusted total amount of the credit changes little over 20 years, ending the time period 5 percent less than in 2015.

Excess Medical Expense Deduction
Estimates were created for the Excess Medical Expense deduction using the assumption that the prevalence of the deduction among seniors and non-seniors will remain constant at 2012 levels. The number of estimated number of taxpayers at all ages using the deduction would grow from 694,000 in 2015 to 872,000 in 2035. Given that the deduction is really a combination of four distinct tax breaks, and with very little historical information available, we applied the annual growth rate of 2.8 percent from a similar federal tax deduction.[2] The amount deducted in 2012 was $3.5 billion. It will grow to $5.4 billion by 2035 and cost the state $162 million in foregone revenue (2012 dollars).

House Bill 64 (Biennial Operating Budget)
It should be noted that the administration's budget proposal would means-test the retirement income credit, the social security deduction, and the senior credit so that they would only be available for taxpayers with federal AGI under $100,000. OBM estimated that total savings

---

[2] The federal medical and dental expense deduction had an annual compound growth rate of 2.8 percent between 2000 and 2011 (author's calculation based on IRS Statistics of Income reports).

from this policy change would be $152 million in FY 2016 and $166 million in FY 2017, most of it from the social security deduction. Given the trends just described, this proposal has merit and should be seriously considered.

Costs of Long-term Care

An important part of the evaluation of tax expenditures is to put them in a larger policy context. What is the state trying to accomplish in the policy arena, and what are the other policy tools that are at the state's disposal? As noted above, the state has a deduction for unsubsidized long-term care insurance premiums. This should be viewed in the context of the state's larger policy objectives with regard to long-term care, also referred to as long-term services and supports. These services provide assistance for individuals who need help with activities of daily living such as dressing, bathing, meal preparation, and household chores. Although most long-term care is delivered informally, some individuals' needs will progress over time to the point where informal care is no longer sufficient.

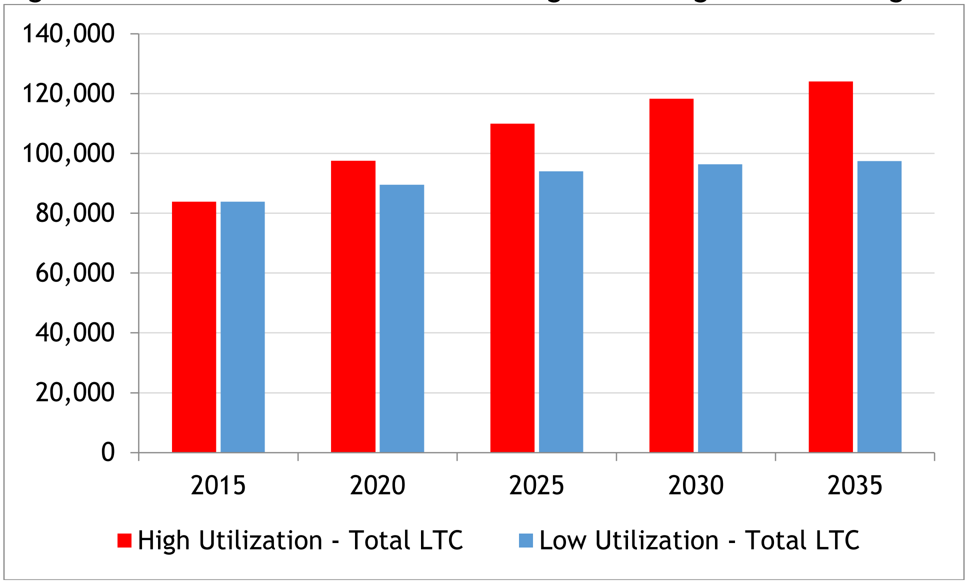
Although the state continues to make progress in rebalancing long-term care utilization away from nursing homes toward less expensive home and community-based options through Medicaid waiver programs such as PASSPORT, the costs of long-term care will continue to grow because of the increased number of elderly Ohioans. The *Aging Ohio* report used two scenarios for projecting future utilization trends among the age 60 and over population.[3] In the low utilization scenario, the number of consumers needing Medicaid long-term care increases by 13,600 individuals between 2015 and 2035. The high utilization scenario increases long-term care utilization by 26,600 individuals.

---

[3] Both scenarios use the same cost projections and a constant FMAP rate, and increase nursing facility costs at the rate of inflation and waiver service costs at 1.6 percent per year before adjusting for inflation. The variance in the scenarios is strictly due to utilization. A low utilization scenario holds the nursing facility census constant at 42,000 individuals and maintains the waiver incidence constant rate of 1.6 percent of the older population, starting with ODM projections of 2015 caseload. In this scenario, total Medicaid long-term care utilization starts at 3.2 percent of the older population in 2015 and then declines slowly to 2.8 percent by 2035.

In a high utilization scenario, the nursing home census starts at 42,000 in 2015 and then is maintained at 1.6 percent of the older population, leading to over 55,000 Medicaid patients in nursing homes by 2035. Waiver or community LTSS enrollment starts at 1.6 percent of population and is increased by one-tenth of one percentage point every five years. Total Medicaid long-term care utilization rises to 3.6 percent of the age 60 and older population by 2035.

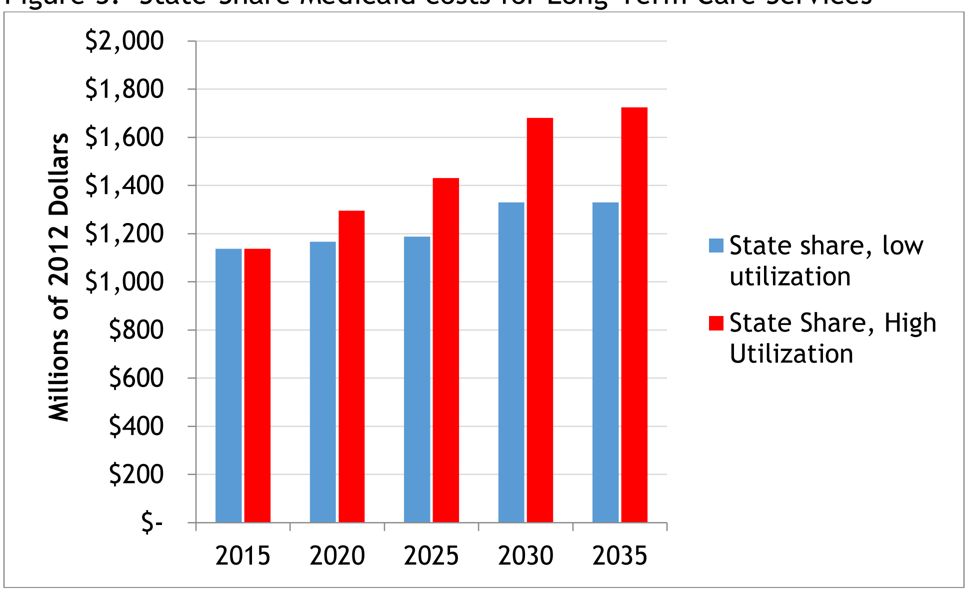
Figure 2. Estimated Number of Ohioans Age 60+ using Medicaid Long-Term Care Services



Source: The Center for Community Solutions

The low utilization scenario will create increased estimated state-share costs over time, but it will be a gradual rise from $1.1 billion to $1.3 billion in inflation-adjusted dollars (Figure 3). The high utilization scenario will see estimated state share costs rise to $1.7 billion by 2035. The cost differences between the two scenarios become more significant over time. The high utilization scenario is $243 million higher in 2025 and nearly $400 million higher in 2035.

Figure 3. State-Share Medicaid costs for Long-Term Care Services



Source: The Center for Community Solutions

Is the deduction for long-term care helping?

Ohio's deduction for unsubsidized long-term care insurance (LTCI) premiums should be viewed in the context of long-term care policy. Nationally, and in Ohio, very few people purchase LTCI despite the existence of tax breaks for this purpose in many states. Just 12 percent of American seniors have coverage.[4] In part, this is because most people underestimate their long-term care needs and the potential expenses they may face. For example, the market rate for a private room at an Ohio nursing facility is $85,000 per year; the cost for a home health aide would be about half that.[5] Most people with a long-term nursing home stay will end up using Medicaid through a spend-down process and will be subject to estate recovery if they have remaining assets.

An academic study from 2009 that analyzed the influence of state credits and deductions on long-term care insurance take-up rates between 1996 and 2005 stated the following:

> States with LTCI tax incentives generally have had higher take-up rates compared to states with none, but our analyses found that tax incentives were responsible for only a small portion of the growth that has occurred. More specifically, state-level tax credits were associated with a modest increase in market take-up for LTCI, but state tax deductions were not associated with any significant change.

The authors went on to conclude that "It is possible that efforts to signal the value of LTC could be more important than the modest difference in price that state-level tax incentives could make." In Ohio, a typical LTCI premium for a 50 year-old woman looking for a $150/day three-year benefit would be about $2500 annually.[6] Tax savings from the deduction for someone with a 3 percent effective rate would be $75, probably not enough to influence the decision. The overall critique of state tax incentives for LTCI is that they are poorly targeted and are used by people who would have probably used them anyway, either because they anticipate a need for long-term care or they have a bequest motivation. Nationally, the average age of a policyholder is 59, with an average income of $87,500 and assets of $325,000.[7]

The federal government attempted to increase the take-up of LTCI through the Long-Term Care Partnership, included in the Deficit Reduction Act of 2005. Ohio is a partnership member. A qualifying partnership plan has an inflation adjustment and must conform to certain other

---

[4] Robert W. Johnson, Senior Fellow, Urban Institute, "Income and Wealth of Older Adults Needing Long-term Services and Supports," Statement before the Commission on Long-term Care, August 1, 2013.

[5] Genworth Financial, Cost of Care Survey 2015, https://www.genworth.com/corporate/about-genworth/industry-expertise/cost-of-care.html

[6] Sample quotation from partnership for long-term insurance website, http://www.partnershipforlongtermcare.com/samplequote.html. This assumes that the policy conforms to partnership for long-term care specifications and would enable the beneficiary to protect assets from Medicaid estate recovery equal to the amount of benefits paid.

[7] Marc A. Cohen, *The Current State of the Long-term Care Insurance Market*, presentation to the 14th Annual Intercompany Long-Term Care Insurance Conference, Rosen Center, Orlando, FL, March 2014, slide 15, "Younger, wealthier and employed individuals are buying policies."

specifications. The incentive for an individual to purchase a plan is that an amount equal to total benefits paid from the insurance policy is shielded from Medicaid estate recovery. Another effort to provide long-term care directly through the federal government through the Affordable Care Acct proved to be short-lived when it could not meet its objective to be self-financing.

Despite federal and state incentives and an aging population, the market for LTCI is collapsing. The number of national insurance carriers shrank from 102 in 2002, to about 20 in 2012, and the number of new policies is flat.[8] Policies in force in Ohio have been flat at about 250,000 since 2009. There are multiple reasons for this, including lower than expected interest rates and lapse rates, and improved mortality. Overall, the private insurance market is expected to remain a small piece of the long-term care financing puzzle.

In short, most Ohioans who will have substantial long-term care needs have few options other than to exhaust their savings and become Medicaid-eligible. From the state perspective, this means a steadily-rising bill for long-term care. It is important for policymakers to think broadly about the various needs of the elderly, what is being financed, and how. Is the current line-up of tax expenditures for seniors and retirees well-targeted and meeting its objectives? Should some incentives be redirected to people at younger ages to better prepare them for retirement? Is the tax code the best mechanism to accomplish these objectives?

Thank you for allowing me to testify today. I would be pleased to answer any questions you may have.

APPENDIX

Major Retirement or Senior-related income tax expenditures, Tax Year 2012

Tax Expenditure	Number of Returns using the credit or deduction	Share of Senior Returns using the credit or deduction	Average per return
Retirement Income Credit	922,296 (All) 669,209 (Senior)	80%	$176 (All) $179 (Senior)
Social Security Deduction	674,154 (All) 543,559 (Senior)	65%	$11,460 (All) $11,962 (Senior)
Medical Expense Deduction	670,827 (All) 383,926 (Senior)	46%	$5,306 (All) $5,850 (Senior)
Military Retirement Deduction	15,463 (Senior) 33,516 (All)	2%	$23,651 (All) $23,958 (Senior)

Source: Ohio Department of Taxation, TY 2012 Detailed Income Statistics; The Center for Community Solutions.

[8] Cohen, *The Current State of the Long-Term Care Insurance Market.*