



## DEPARTMENT OF AUDITS AND ACCOUNTS

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December 21, 2015

Honorable Jesse Petrea  
State Representative  
404-D Coverdell Legislative Office Building  
Atlanta, Georgia 30334

SUBJECT: Fiscal Note  
House Bill (LC 33 6243)

Dear Representative Petrea:

The Georgia State University Fiscal Research Center provided the following narrative on the revenue impact of this bill:

The subject bill proposes to exempt from income taxation all military retired pay and survivor benefits received by Georgia taxpayers from the United States military. In addition, the bill proposes to increase the excise tax on cigarettes from 37 to 55 cents per pack. The effective date of the bill, as written, would be January 1, 2017. The bill includes a sunset date for both provisions of December 31, 2027.

After accounting for the effects of the existing retirement income exclusions for Georgia taxpayers age 62 or older, and for growth and other assumptions detailed in the attached appendix, the exclusion of military retired pay and survivor benefits is estimated to result in revenue losses to the state of between \$56 million and \$96 million for FY 2018, the first fiscal year to be fully impacted based on the effective date.

The revenue impact of the increase in the excise taxes on cigarettes is estimated to be between \$85 and \$89 million in FY 2018, decreasing to between \$81 and \$86 million by FY 2021. Due to higher overall retail spending on tobacco products under certain assumptions, a small positive effect on state sales tax revenue is included in the projections as well, adding between \$0.9 and \$1.6 million in FY 2018 and smaller amounts in future periods.

Combined projected revenue effects for FY 2017 through FY 2021 are provided in Table 1. Details of the analysis and assumptions are included in the attached appendix.

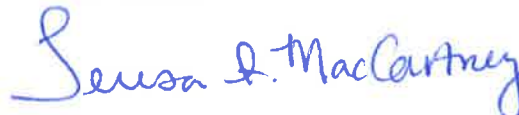
**Table 1: Estimated Revenue Effects of LC 33 6243**

(\$ millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
<b>Retired Pay Exclusion:</b>					
Higher Revenue Estimate	(\$23.2)	(\$56.0)	(\$56.5)	(\$57.0)	(\$57.5)
Lower Revenue Estimate	(\$39.2)	(\$95.7)	(\$99.4)	(\$103.4)	(\$107.5)
<b>Cigarette Tax Increase (excise and sales tax effects):</b>					
Higher Revenue Estimate	\$44.9	\$89.2	\$88.2	\$87.1	\$86.1
Lower Revenue Estimate	\$44.3	\$85.8	\$82.7	\$81.8	\$81.0
<b>Total State Revenue Effect:</b>					
Higher Revenue Estimate	<b>\$21.6</b>	<b>\$33.2</b>	<b>\$31.7</b>	<b>\$30.1</b>	<b>\$28.6</b>
Lower Revenue Estimate	<b>\$5.1</b>	<b>(\$9.9)</b>	<b>(\$16.8)</b>	<b>(\$21.5)</b>	<b>(\$26.5)</b>

Sincerely,



Greg S. Griffin  
 State Auditor



Teresa A. MacCartney, Director  
 Office of Planning and Budget

### **Military Retired Pay and Survivor Benefits Exclusion**

To estimate the revenue impact of exempting military retired pay and survivor benefits from income taxation, it is first necessary to account for the fact that taxpayers age 62 to 64 are already exempt from Georgia income taxes on up to \$35,000 of retirement income and those over age 65 are exempt on up to \$65,000 of retirement income. According to the Department of Defense Statistical Report on the Military Retirement System for FY 2014 (the latest available), 94,615 persons retired from the U.S. military resided in Georgia as of September 2014, of whom 88,602 were receiving military retired pay. Of those receiving retired pay, approximately 41.7 percent were over age 65. Further age breakdowns are only available on military retirees nationally, but on the basis of national data, it is estimated that approximately 9.7 percent of the total are age 62 to 64. Thus the total share of Georgia recipients of military retired pay who are already exempt from taxes on some or all of their retirement income is estimated to be about 51.4 percent. Note also that survivor and dependent benefits paid by the Department of Veterans Affairs are not included in this analysis as these payments are not currently subject to income tax, thus only Department of Defense survivor benefits are included.

Georgia military survivor (SBP) beneficiaries numbered 13,500 as of September 2014, with 11,165 or 82.7 percent of recipients over age 65. Based on the finer age groupings in national figures, it is assumed that 3.3 percent of recipients are age 62-64, bringing the total share of recipients eligible for some amount of retirement income exclusion to about 86 percent.

Growth rates of Georgia recipients of military retired pay have differed by age group in recent years, with the over-65 group growing by about 2.8 percent annually, on average, since 2006 and the under-65 group growing 0.1 percent annually over the same period. In 2014, the number under age 65 actually fell for the third year in a row and is down by 0.8 percent annually from 2012, while the number over 65 grew by 3.3 percent annually over the same period. For purposes of projecting military retired pay recipients, it is assumed that the number above age 65 will grow by between 2.5 percent and 4 percent annually while those below age 65 will grow by -1.5 percent to 0.5 percent annually.

Growth in SBP beneficiaries, which had been running 3.5 percent annually from 2006-2012, slowed to 0.4 percent annually the last two years. Growth in the 65+ age group averaged 1.0 percent annually since 2012 while the under-65 age group declined by 2.2 percent annually. To project survivor benefit recipients, growth rates of zero to 1.5 percent are assumed for the 65+ age group and -1.0 percent to -2.5 percent are assumed for the under-65 group.

Projected numbers of retired pay and survivor benefit recipients in Georgia for tax years 2016 through 2021 are provided in Table 2.

**Table 2: Projected Total Military Retired Pay and Survivor Benefits Recipients, by Age Group**

		TY 2016	TY 2017	TY 2018	TY 2019	TY 2020	TY 2021
Under age 62	High	45,032	45,223	45,416	45,611	45,807	46,004
	Low	43,278	42,608	41,947	41,297	40,659	40,029
Age 62-64	High	9,390	9,437	9,483	9,529	9,576	9,623
	Low	9,021	8,885	8,752	8,620	8,489	8,362
Over age 65	High	51,506	53,279	55,118	57,027	59,007	61,062
	Low	50,024	50,995	51,991	53,012	54,058	55,130
Total	High	105,928	107,939	110,017	112,167	114,390	116,689
	Low	102,323	102,488	102,690	102,929	103,206	103,521

Average military retired pay differs by age as well, with the average for Georgia recipients over age 65 at \$26,905 annualized as of September 2014 and for those under age 65 at \$24,566. Average SBP payments as of September 2014 were \$11,860 annualized for recipients over age 65 and \$8,778 for those under age 65. Payments are adjusted annually based on the prior year's consumer price index (CPI) inflation rate.

The official COLA rate for 2015 was set at 1.7 percent based on CPI inflation for the preceding year. COLA rates for 2016 and beyond are assumed to be in the range of 1.5 to 2.5 percent annually. The resulting projected average pay figures, together with the projected retiree and survivor figures from Table 2, result in high and low total retiree pay and survivor benefit projections, by age group, as shown in Table 3.

**Table 3: Projected Total Military Retired Pay and Survivor Benefits, by Age Group**

(\$ millions)		TY 2016	TY 2017	TY 2018	TY 2019	TY 2020	TY 2021
Under age 62	High	\$1,106	\$1,139	\$1,173	\$1,208	\$1,244	\$1,281
	Low	\$1,062	\$1,062	\$1,072	\$1,082	\$1,092	\$1,102
Age 62-64	High	\$237	\$244	\$251	\$259	\$267	\$275
	Low	\$228	\$228	\$230	\$232	\$234	\$236
Over age 65	High	\$1,252	\$1,331	\$1,415	\$1,504	\$1,600	\$1,701
	Low	\$1,216	\$1,262	\$1,320	\$1,382	\$1,447	\$1,515
Total	High	\$2,595	\$2,714	\$2,839	\$2,971	\$3,110	\$3,257
	Low	\$2,506	\$2,551	\$2,622	\$2,696	\$2,773	\$2,854

The retirement income exclusion available to the 62-64 and over age 65 groups requires different assumptions across the groups as to effective tax rates. For all Georgia full-year resident taxpayers (excluding those with negative Federal AGI), the weighted average effective tax rate—net tax divided by taxable income—was 5.49 percent in tax year 2012. Thus for military retirees under age 62, a range of 5.25 percent to 5.50 percent is assumed going forward. For those eligible for the retirement exclusion, much of their military retired pay (if not all) is already excluded, so this measure of effective tax rates would be misleading. Instead, net tax is divided by federal adjusted

gross income, which would include military retired pay. On this basis, the effective tax rate for all Georgia retirees in 2012 was 1.94 percent. Those retirees with AGI below the exclusion limits will still have tax liabilities to the extent they have earned income in excess of \$4,000, but no liability associated with their retirement income. Those with higher retirement income, on the other hand, may be taxable on some or all of their military retired pay or survivor benefits. It is conceivable, then, that no military retired pay or survivor benefits received by age 62 or older taxpayers is currently taxable, so high and low effective tax rates of 2 percent and zero are assumed for both the 62-64 age group and those age 65 or older. From these assumptions and the retired pay figures in Table 3, projected tax liabilities on military retired pay under current law are as shown in Table 4.

**Table 4: Projected Taxes on Military Retired Pay, by Age Group**

<i>(\$ millions)</i>		TY 2016	TY 2017	TY 2018	TY 2019	TY 2020	TY 2021
Under age 62	High	\$60.8	\$62.6	\$64.5	\$66.4	\$68.4	\$70.5
	Low	55.8	55.8	56.3	56.8	57.3	57.9
Age 62-64	High	4.7	4.9	5.0	5.2	5.3	5.5
	Low	0.0	0.0	0.0	0.0	0.0	0.0
Over age 65	High	25.0	26.6	28.3	30.1	32.0	34.0
	Low	0.0	0.0	0.0	0.0	0.0	0.0
Total	High	\$90.6	\$94.1	\$97.8	\$101.7	\$105.7	\$110.0
	Low	55.8	55.8	56.3	56.8	57.3	57.9

These figures are adjusted to a fiscal year basis assuming that tax collections are substantially all through withholding and thus are assumed to be spread evenly over the year with the first five calendar months' withholding payments collected in the fiscal year ending in June of that calendar year and the balance collected in the following fiscal year. That is, for example, 7/12 of the TY 2016 and 5/12 of the TY 2017 tax liabilities would be collected in FY 2017. Given the January 1, 2017 effective date of the exemption, FY 2017 revenues from TY 2016 withholding would not be affected; that is, the FY 2017 revenue effect would reflect foregone withholding only on the first five months of TY 2017 retired pay. The results are shown in Table 1 of the fiscal note.

**Increase in the Cigarette Excise Tax**

Cigarette and smokeless tobacco use has experienced a consistent decline in Georgia since 2005, according to the Centers for Disease Control State Tobacco Activities Tracking and Evaluation System (STATE). Based on statistics from the Georgia Department of Revenue (DOR) this decline in use has resulted in a persistent decline in revenues generated by the current excise tax on tobacco products since FY 2005, though FY 2014 did see a slight increase.

In addition to the expected continuation of this decline in consumption, an increase in excise taxes would be expected to have behavioral effects due to higher retail prices as more people reduce the amounts they consume, quit outright, or switch to alternatives. Prior to the prevalence of e-cigarettes, an untaxed potential substitute for traditional cigarettes, empirical research into cigarette consumption found, on average, that a 1 percent increase in the final price of a pack of cigarettes results in a 0.48 percent decline in the quantity of cigarettes purchased (a -0.48 price

elasticity), though estimates vary. More recent research reveals that, in the presence of e-cigarettes, the behavioral response to a rise in cigarette prices is much stronger. According to a 2013 Citi Research report cited in Forbes and the South African Journal of Medicine, a 1 percent increase in cigarette prices may be expected to reduce consumption in the long-run by 0.8 percent (-0.8 price elasticity) given the availability of e-cigarettes.

LC 33 6243 proposes to increase the excise tax on a pack of cigarettes from 37¢ cents to 55¢, effective January 1<sup>st</sup>, 2017 representing an increase in average retail price of cigarettes of approximately 3.4 percent in 2017. It is assumed that the increased cost of taxes is completely passed through to consumers in higher retail prices.

Key assumptions in high and low revenue estimates are as follows. Table 5 details the results of the excise tax analysis.

- Between FY 2005 and FY 2014, revenue raised by the excise tax on tobacco has been declining at an average annual rate of 1.27 percent. Absent a change in cigarette taxes, this rate of decline is assumed to continue.
- Historical price trends are also assumed to continue in the absence of the proposed increase. According to STATE data, the average price of cigarettes in Georgia increased at an average annual rate of 3.6 percent between 2005 and 2014.
- The low revenue estimates assume a relatively larger behavioral response to the tax-induced price increase in the number cigarette packs purchased. Specifically, the -0.8 long-run price elasticity estimate is assumed after the first year of higher prices; the first year response is assume to be half that, a price elasticity of -0.4. The high revenue estimate assumes a less elastic or smaller behavioral response to the tax-induced price increase, using a -0.3 price elasticity for all years, the low end of the range most often cited.

**Table 5. Cigarettes Prices, Consumption, and Projected Revenues Under Alternative Consumption Responses**

(\$ millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
<b>Cigarette Retail Price Per Pack</b>					
Current Law and Baseline Trend	\$5.33	\$5.52	\$5.72	\$5.93	\$6.14
Under LC 33 6243	\$5.51	\$5.70	\$5.90	\$6.11	\$6.32
<b>Cigarette Consumption (millions of packs)</b>					
Low Response, High Revenue Case	506	497	491	485	479
High Response, Low Revenue Case	505	492	483	477	472
<b>Projected Excise Tax Revenue Gains Under LC 33 6243</b>					
Low Response, High Revenue Case	\$44.1	\$87.7	\$86.6	\$85.6	\$84.6
High Response, Low Revenue Case	\$43.6	\$85.0	\$82.3	\$81.5	\$80.6

Finally, because tobacco products are also subject to sales taxes charged on the total retail price including excise taxes, it is expected that, under certain assumptions, there would be a small, but

material, increase in sales tax revenue as a result of the bill as well. The reason is that, to the extent that total expenditures for tobacco products increase as a result of the bill (i.e. the increase in price more than offsets the decline in quantity purchased), consumers would have to either shift consumption from other goods and services, some of which would not be taxable, or increase total consumption (reduce saving) to support the increased tobacco spending. Assuming no change in saving and a proportional reduction in other consumption types, it is estimated that around 64 cents of every dollar of increased tobacco expenditures would come from consumption that is not now taxed. Under the high excise tax revenue case in the fiscal note, the increase in state sales tax revenue could be as high as around \$.8 million in the first year. Under the low revenue case, which assumes a stronger negative behavioral response after the first year to the tax-induced price increases, the effect after the first year would not be material. Table 6 provides the estimated effects on state sales tax revenues for FY 2017 through FY 2021.

**Table 6. Projected State Sales Tax Revenue Gains under LC 33 6243**

(\$ millions)	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
High Excise Revenue Case	\$0.8	\$1.6	\$1.5	\$1.5	\$1.5
Low Excise Revenue Case	\$0.7	\$0.9	\$0.4	\$0.4	\$0.4