RETIREMENT SECURITY PROJECT

Social Security Coverage for State and Local Government Workers: A Reconsideration

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The Issue

- 1/4 of SLGWs are not covered by SS in their current jobs.
  - Some of those are covered under spousal provisions.
  - Some of those are covered under previous jobs.

- Should SLGWs be brought into SS via mandatory coverage?
  - Focus on newly-hired SLGWs

- Traditional arguments (focusing on SS) suggest that mandatory coverage would be a good idea.

- How does the pension crisis affecting states and localities influence this issue?
  - Increased need for retirement security
  - Increased financing problems at state level

Background

- SLGWs were not included in original SS coverage in the 1930s because of constitutional concerns about whether the federal government could tax the states.

- In 1950, states given the option of covering workers in SS.

- Various extensions of coverage for SLGWs in the 1950s

- SS reforms in 1983 prohibited state and local governments from leaving SS once enrolled (and covered all new federal employees).
  - Resulted from Texas counties leaving SS

- In 1986, all newly hired SLGWs covered by Medicare.

- In 1990, SS coverage was mandated for all SLGWs not covered by a retirement program.

From the Perspective of SS… Mandatory Coverage is (Almost) a No-Brainer

- Improves Social Security finances over the next few decades (closes 5 percent of 75-year gap) due to younger new hires joining system. Improvement largely disappears as they age and begin to receive benefits and then turns negative.

- Improves inter-generational equity by having SLGWs contribute towards SS legacy costs

- Improves intra-generational equity by having SLGWs contribute to cost of income redistribution
  – In both cases, SLGWs are currently "free riders"

- Improves retirement benefits
  – Security (by diversifying sources)
  – Level (probably, depending on SL response)
  – Quality (automatic full inflation indexing, dependent, survivor, spousal, and disability)

More on Benefits of SS Coverage

- SS coverage particularly valuable for SLGW workers because of slow vesting in SL pension plans
  - Vesting periods longer in SL plans than private (Johnson 2014)
  - Even after being vested, workers often have to be employed for a significant period of time just to get contributions back. (Extremely back-loaded)
  - Particular issue for teachers

WEP and GPO

- Windfall Elimination Provision aims to avoid paying higher benefits to people who worked a few years at high wages, but does so unevenly and is confusing.
- Government Pension Offset addresses SLGW workers who were not covered by SS but who were eligible for a SS spousal benefit. GPO reduces the spousal benefit by 2/3 of the amount of the non-covered pension.

SLGW Coverage Would Eliminate Need for WEP and GPO

- Neither the GPO or WEP fix is ideal. Both are controversial.
- Full coverage of SLGW under SS would eliminate the need for both WEP and GPO.
- SSAB now proposes to eliminate the WEP and instead use newly available history of total earnings to calculate benefits proportional to contributions.

Wide Support for Mandatory Coverage … in the SS World

- Virtually all major commissions and a wide variety of major reform proposals over the last 20 years support mandatory coverage, despite massive differences in the overall proposed structure of SS.
  - SS Advisory Board (1997, all three groups)
  - National Commission on Retirement Policy (1999)
  - Domenici-Rivlin (2010)
  - Bowles-Simpson (2010)
  - Aaron-Reischauer (1998)
  - Shoven-Schieber (1999)
  - Diamond-Orszag (2004)

- Exception was the Bush (2001) Commission
  - Co-Chair Moynihan indicated enormous political pressure on this issue.

From the Perspective of SL Pensions … It's (More) Complicated

- SL pension problems highlight issues of retirement income security and quality and the risks that SLGWs face, suggesting that mandatory coverage would be helpful.

- But mandatory coverage would raise state costs without doing anything directly to deal with existing underfunding.

SS Coverage among SLGWs

- As noted, about one quarter of SLGWs are not covered by SS.
  - Some of those have coverage through spousal benefits.
  - Some of those have coverage through prior jobs.
  - Uncovered workers with benefits from spouses or prior job may be hit with reductions due to Government Pension Offset and Windfall Elimination Provision.

- Highest rates of non-coverage are in OH (97%), MA (96%), NE (82%), LA (72%), CO (71%), CA (56%), TX (52%) and IL (45%).

- Those eight states account for more than 70 percent of all uncovered SLGWs.

Retirement Security Issues – 1

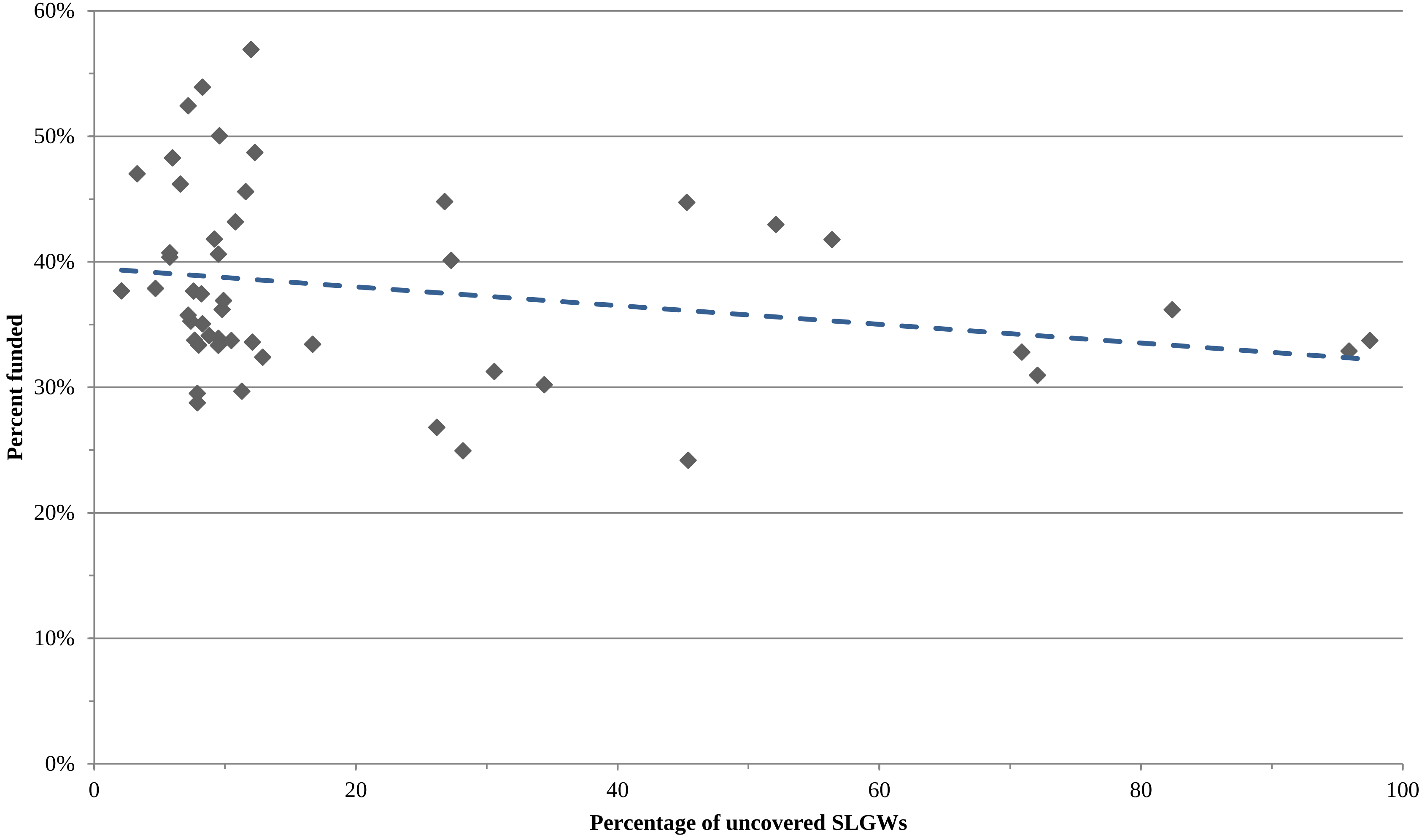
- Pension underfunding and SS coverage of SLGWs

- States that have lower coverage rates for SLGWs tend to have larger pension underfunding problems (see Figures, next 3 slides).
  - Caveat: the figures use data from different years and different sources
  - Figures use data from State Budget Solutions
  - We obtain similar results when we use data from Pew or Novy-Marx and Rauh

- The relation may be due to need to cover full costs of retirement benefits, but may also be due to local economic conditions and political decisions.

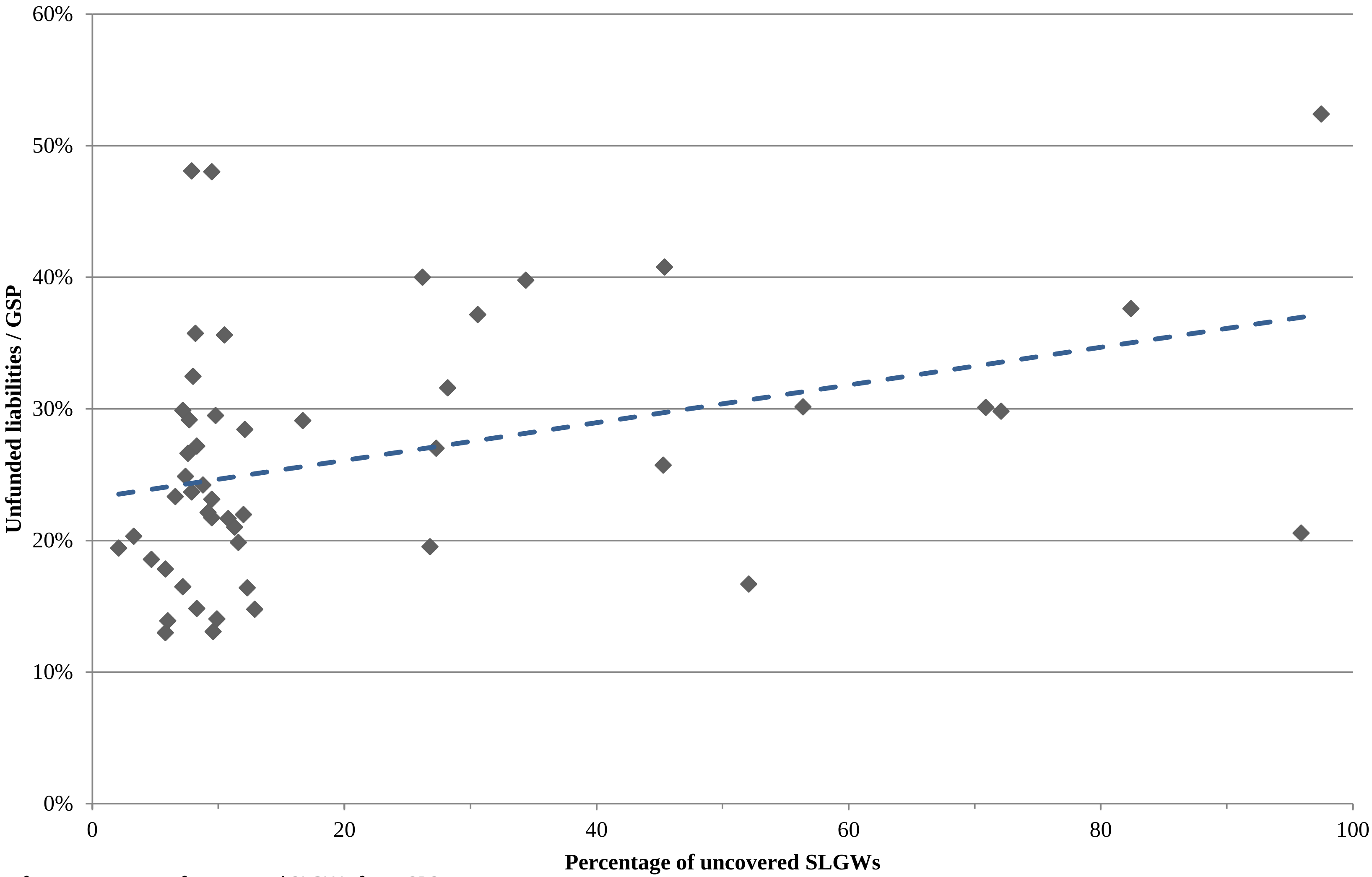
- NOT a causal relationship, just a correlation

Uncovered SLGWs and Funding Ratios



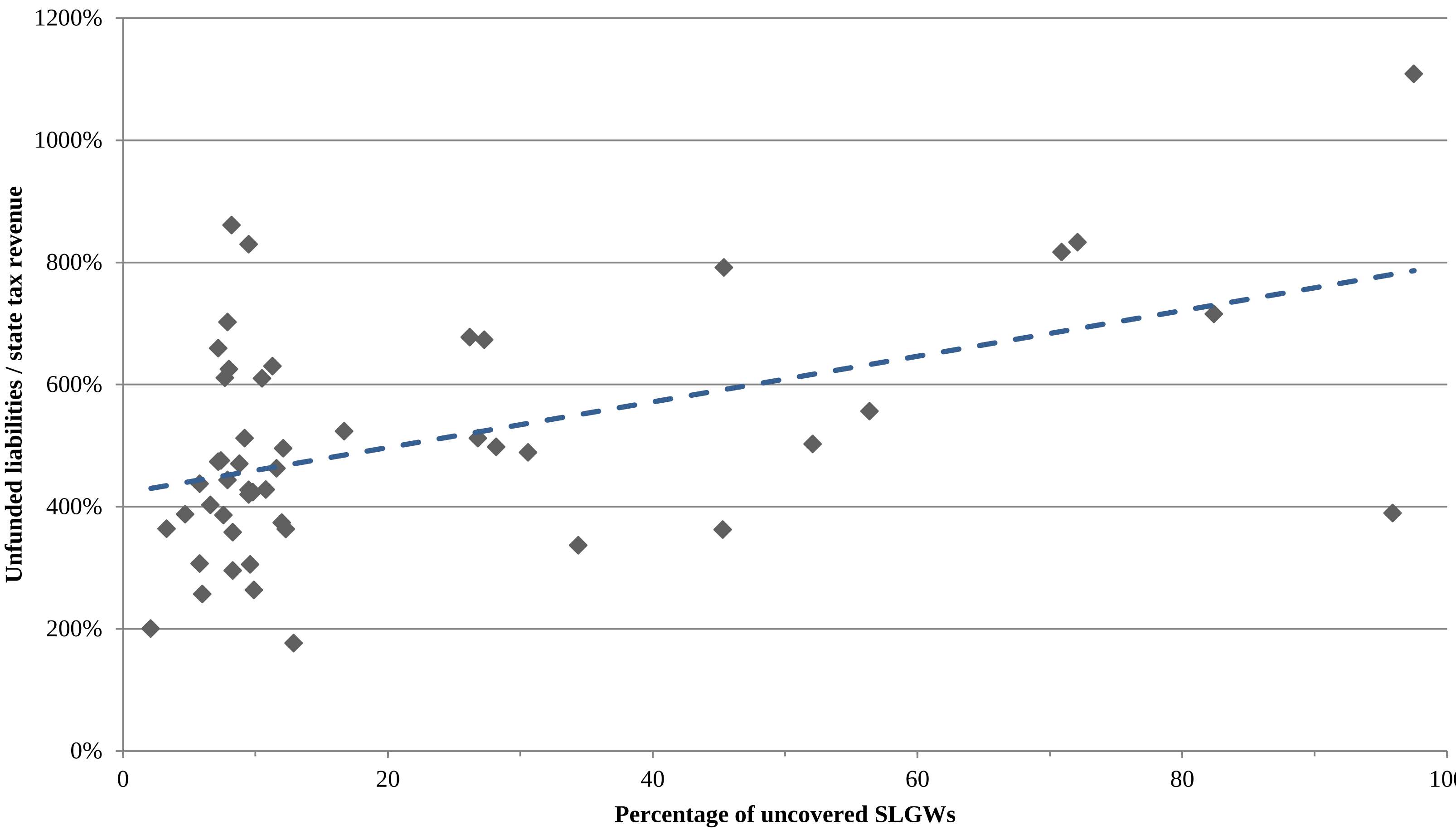
Source: Data for percentages of uncovered SLGWs from CRS [2011]. Data on funding ratios from SBS [2013].

Uncovered SLGWs and Unfunded Liabilities as a Percentage of GSP



Source: Data for percentages of uncovered SLGWs from CRS [2011]. Data on unfunded liabilities from SBS [2013]. Data on GSP from BEA [2014].

Uncovered SLGWs and Unfunded Liabilities as a Percentage of State Tax Revenue

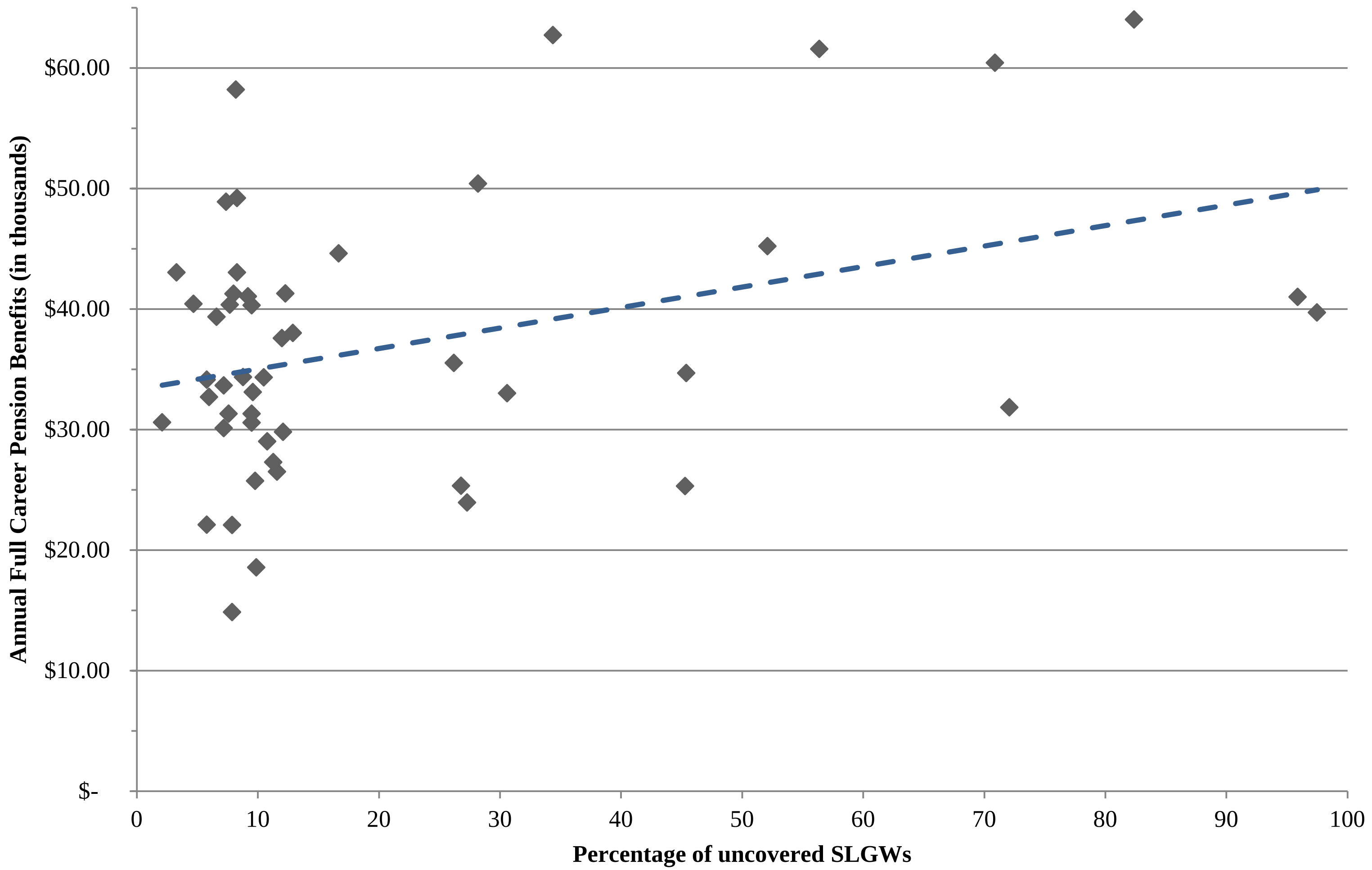


Source: Data for percentages of uncovered SLGWs from CRS [2011]. Data on unfunded liabilities from SBS 2013]. Data on state tax revenue from Census [2013].

Retirement Security Issues - 2

- State pension benefit levels and SS coverage of SLGWs
- Munnell (2005) finds that states with lower SS coverage for SLGWs have higher benefit accrual rates in their pensions.
  - Brown et al. (2011) argue that differences in SS coverage explain much of the differences in DB plan generosity across states.
- We find similar results, using more recent data (See Figure, next slide).
  - Similar cautions about the data
  - Similar sensitivity analysis with other data sources
- States that have lower SS coverage for SLGWs tend to pay higher pension benefits FOR FULL CAREER WORKERS.
  - Still the issue of how workers with shorter job tenures are treated
- May be due to need to cover entire retirement benefit amount and offset loss of guaranteed Social Security coverage
- Again, we emphasize we are not claiming a causal relationship.

Uncovered SLGWs and State Pension Benefits



Source: Data for percentages of uncovered SLGWs from CRS [2011]. Data on state pension benefits from Biggs [2014].

Cost Issues

- Depends on how state and local pensions react

- Munnell et. al (2014) find that if SL pensions react to preserve first-year retirement benefits, costs of new hires would rise by 6 percent of payroll. In addition, new hires would have to pay their share of the payroll tax.

- This would be about 0.15 percent of state budgets over the next five years, rising to 0.9 percent in the long run.

- The initial effect is small because
  - Labor cost is only part of state budgets.
  - New hires are a small part of labor costs.
  - Payroll taxes are a small part of the costs of new hires.
  - As new hires become a greater proportion of workforce, total cost would climb.

- Preserving first year benefits would lead to greater lifetime benefits under the SS- and-pensions combination than under current pensions, because SS offers higher quality benefits as noted above.

- Note that costs would go up even if lifetime benefits are unchanged because some of the costs would be going towards the paying of SS legacy burdens.

Constitutional Issues

- Issue is whether the federal government can impose taxes on the states
  - In 1983, federal law prohibited states from leaving SS.
  - All SLGWs hired after 1/1/86 are required to be enrolled in Medicare.
  - In 1990, federal law required states to enroll workers without a pension into SS.
  - All of those actions appear to impose federal mandates and taxes on state governments.

- SS Advisory Council, GAO, Aaron-Reischauer believe there is not a problem. Most other SS studies do not even examine the issue.

Wide Opposition to Mandatory Coverage … in the SL Pension World

- Virtually every SL government and every SLGW group that has reported an opinion opposed mandatory coverage of SLGWs
  - Costs are the most common explanation
  - Fear of benefit reductions or complete system overhaul
  - What is the role of free-riding?

Conclusion

- Proponents emphasize the benefits of mandatory coverage.

- Opponents emphasize the costs.

- Both sets of arguments can be, and probably are, true simultaneously.

- Policymakers will have to balance these competing concerns.