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

William G. Gale, Sarah E. Holmes, and David C. John

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I. Introduction

Since it was created in 1935, Social Security has grown from covering about half of the work force to covering nearly all workers. The largest remaining exempted group is a subset of state and local government workers (SLGWs). As of 2008, Social Security did not cover about 27 percent of the 23.8 million SLGWs (Congressional Research Service 2011). Non-coverage of SLGWs is concentrated in certain states scattered around the country and includes workers in a diverse set of jobs, ranging from administrators to custodial staff. Some police and fire department employees are not covered. About 40 percent of public school teachers are not covered by Social Security (Kan and Alderman 2014).

Under current law, state and local governments that do not offer their own retirement plan must enroll their employees in Social Security. But if it does offer a retirement plan, the state or local government can choose whether to enroll its workers in Social Security.

This paper reviews and extends discussion on whether state and local government workers should face mandatory coverage in Social Security.[1] Relative to earlier work, we focus on links between this issue and recent developments in state and local pensions. Although some of the issues apply equally to both existing and newly hired SLGWs, it is most natural to focus on whether newly hired employees should be brought into Social Security.[2]

The first thing to note about this topic is that it is purely a transitional issue. If all SLGWs were already currently enrolled in Social Security, there would not be a serious discussion about whether they should be removed. For example, there is no discussion of

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[1] Earlier surveys of these issues provide excellent background. See Government Accountability Office (1998), Munnell (2005), and Congressional Research Service (2011).

[2] A variety of related issues are beyond the scope of the paper, including in particular how best to close gaps between promised benefits and accruing assets in state and local pension plans and the level of those benefits.

whether the existing three quarters of all SLGWs that are enrolled in Social Security should be removed from coverage.

Bringing state and local government workers into the system would allow Social Security to reach the goal of providing retirement security for all workers. The effects on Social Security finances are mixed. Bringing SLGWs into the system would also help shore up Social Security finances over the next few decades and, under common scoring methods, push the date of trust fund insolvency back by one year, but after that, the cost of increased benefit payments would offset those improvements.

Mandatory coverage would also be fairer. Other workers pay, via payroll taxes, the "legacy" costs associated with the creation of Social Security as a pay-as-you-go system. Early generations of Social Security beneficiaries received far more in payouts than they contributed to the system and those net costs are now being paid by current and future generations. There appears to be no convincing reason why certain state and local workers should be exempt from this societal obligation. As a result of this fact and the short-term benefit to the program's finances, most major proposals and commissions to reform Social Security and all commissions to shore up the long-term federal budget have included the idea of mandatory coverage of newly hired SLGWs.

While these issues are long-standing, recent developments concerning state and local pensions have raised the issue of mandatory coverage in a new light. Linking the funding status of state and local pension plans and the potential risk faced by those employees with the mandatory coverage question is a principal goal of this paper. One factor is that many state and local government pension plans are facing significant underfunding of promised pension benefits. In a few municipal bankruptcy cases, the reduction of promised benefits for both current employees and those who have already retired has been discussed. The potential vulnerability of these benefits emphasizes the importance of Social Security coverage, and naturally invites a rethinking of whether newly hired SLGWs should be required to join the program. On the other hand, the same pension funding problems imply that any policy that adds newly-hired workers to Social Security, and thus requires the state to pay its share of those contributions, would create added overall costs for state and local governments at a time when pension promises are already hard to meet. The change might also divert a portion of existing employee or employer contributions to Social Security and away from the state pension program.

We provide two key results linking state government pension funding status and SLGW coverage. First, we show that states with governmental pension plans that have greater levels of underfunding tend also to have a smaller proportion of SLGW workers that are covered by Social Security. This tends to raise the retirement security risks faced by those workers and provides further fuel for mandatory coverage. While one can debate whether future public pension commitments or future Social Security promises are more risky, a solution resulting in less of both is the worst possible outcome for the workers in question. Second, we show that state pension benefit levels for career workers are somewhat compensatory, in that states with lower rates of Social Security coverage for SLGWs tend to have somewhat higher pension benefit levels. The extent to which promised but underfunded benefits actually compensate for the higher risk to individual workers of non-Social Security coverage is an open question, though.

Mandatory coverage of newly hired SLGWs could improve the security of their retirement benefits (by diversifying the sources of their retirement income), raise average benefit levels in many cases (even assuming significant changes in state and local government pensions in response to mandatory coverage), and would improve the quality of benefits received, including provisions for full inflation indexation, and dependent, survivor and disability benefits in Social Security that are superior to those in most state pension plans. The ability to accrue and receive Social Security benefits would be particularly valuable for the many SLGWs who leave public service either without ever having been vested in a government pension or having been vested but not reaching the steep part of the benefit accrual path.

Just as there is strong support for mandatory coverage in the Social Security community and literature, there is strong opposition to such a change in elements of the state and local government pension world. The two groups that are most consistently and strongly opposed to mandatory coverage of newly hired SLGWs are the two parties most directly affected – state and local governments that do not already provide such coverage and their uncovered employees. Opponents cite the higher cost to both employees and the state and local government for providing that coverage and the potential for losing currently promised pension benefits. They note that public pensions – unlike Social Security – can invest in risky assets and thus can provide better benefits at lower cost. This, of course, is a best-case alternative as losses among those risky assets could also increase pressure on pension finances.

There is nothing inconsistent about the two sides of these arguments; one set tends to focus on benefits, the other on costs. They can be, and probably are, all true simultaneously. There is also a constitutional issue that used to hang over the whole debate – whether the federal government has the right to tax the states and local government units in their roles as employers – but that seems resolved at this point.

Section II of this paper discusses the history and current status of Social Security coverage for SLGWs. Section III discusses mandatory coverage in the context of Social

Security funding and the federal budget. Section IV discusses the issues in the context of state and local budgets, existing pension plans, and the risks and benefits to employees of those governments. Section V concludes.

II. History

President Roosevelt signed the Social Security Act on August 15, 1935. Until a major reform was passed in 1950, the program covered only about half of the work force (DeWitt 2010). Most of the covered workers were employed in either commerce or industry. Federal, state, and local government employees were excluded, as were farm workers, domestic workers, the self-employed, employees in the non-profit and charitable sectors, professionals (including doctors, lawyers, and ministers) and people aged 65 and older. While there were many reasons why different groups were not covered initially, a key factor behind the exclusion of SLGWs was uncertainty about whether the federal government was constitutionally permitted to impose taxes – in this case, employer payroll taxes – on state and local governments (GAO 1998). Zorn (1999) suggests that the rise of state- and local-level pension programs also played an important role in justifying exclusion of SLGWs. Since then, however, Congress has moved from total exclusion of SLGWs from Social Security to a position that currently includes about three-fourths of them. Covering the remaining one quarter of SLGWs would not be a radical step or out of line with historical trends.

In 1950, enactment of section 218 of the Social Security Act gave states the option to voluntarily extend Social Security coverage to SLGWs not participating in another retirement program (42 U.S.C. § 418 1950). All states eventually signed such agreements, and were allowed to designate which employees were covered and which would remain outside of Social Security.

In the 1950s, Social Security coverage was extended to many other previously excluded groups. As part of this expansion, most employees of state and local governments were allowed to choose Social Security coverage even if they already had access to a pension program, but only if a majority of participating workers in a given pension plan agreed to the change. However, police officers and firefighters were notably excluded. (P.L. 761 1954). In 1956, nine states were allowed to split their government employees' retirement programs into two parts (one for employees covered by Social Security, and one for employees participating in a pension plan) (Senate 1956).

As the Social Security program began to run into financial difficulties in the late 1970s, the prospect of payroll tax increases induced several jurisdictions to explore withdrawing from the system, and three Texas counties – Galveston, Brazoria, and Matagorda – actually did leave. Fearing that additional withdrawals would further strain the system's finances, Congress prohibited state and local governments that were already participating from leaving Social Security in 1983 as part of a broader reform of the program.[3] State and local governments could still choose to provide Social Security coverage to new groups of workers, but the decision would be one-way and irrevocable (P.L. 98-21 1983).

In 1986, Medicare coverage was mandated for all newly hired SLGWs, unless their positions were specifically excluded by law. This followed a 1966 move under which employees covered for Social Security under a Section 218 agreement were automatically covered by Medicare.

Further expansion of SLGW coverage followed. In 1990, coverage was mandated for all SLGWs not covered by another retirement program or a Section 218 agreement. In 1994, all

[3] The 1983 Social Security Amendments also brought federal government workers into Social Security.

states were allowed to extend Social Security and Medicare to police and firefighters who were already covered by a retirement system. In 2004, after hearing that some SLGWs were confused as to whether their specific job was covered by Social Security, public employers were required disclose to workers whether they were covered. In addition, two more states – Kentucky and Louisiana – were allowed to provide a divided retirement system, split between workers covered by both Social Security and a pension plan and workers who are part of a pension plan that does not include Social Security (P.L. 108-203 2004).

III. Mandatory Coverage and the Social Security System

In this section, we discuss SLGW coverage from the perspective of the Social Security program. Mandating coverage would improve Social Security trust fund balances in the near future, allow Social Security to provide more universal coverage, and improve the inter- and intra-generational equity in the program. For these reasons, almost all major Social Security reform plans of the last twenty years propose mandatory coverage for newly hired SLGWs.

A. Social Security Finances

Mandatory coverage for newly hired SLGWs would have a net positive effect on the Social Security Trust Funds over the next 75 years. According to the 2014 Trustees report, the projected 75-year actuarial deficit for Social Security was 2.88 percent of taxable payroll (Social Security Administration 2014a). The Social Security Administration estimated that mandatory coverage beginning in 2014 would reduce the 75-year actuarial balance by 0.15 percent of taxable payroll[4] (about 5 percent of the overall deficit) and would push back the date of Trust Fund exhaustion to 2034, one year later than under current law (Social Security Administration

[4] The current payroll tax cap is $118,500.

2014b, 2014c). The inclusion of newly hired SLGWs would help the trust fund over the next few decades because the revenues from inclusion would be front-loaded relative to the benefit payments. Congressional Budget Office (2013) reports estimates from the Joint Committee on Taxation indicating that mandatory coverage for newly hired SLGWs as of January 1, 2014 would raise $81 billion in additional revenue between 2014 and 2023.

However, over time these additional revenues would be offset by the need to pay benefits to the newly covered workers. The scoring assumes that most of the newly covered SLGWs would be young and many decades away from collecting benefits. It also assumes that because only newly hired SLGWs are subject to the mandate, the proportion of those workers with Social Security coverage would gradually increase as a percentage of the whole over time.

According to the Social Security Administration (2014b, 2014c), assuming that mandatory coverage was implemented in 2015, new revenue would build from 0.02 percent of taxable payroll gradually rising to 0.30 percent by 2030 and reaching 0.49 percent of taxable payroll by about 2075. In the early years, additional benefit payments would be minimal, staying below 0.10 percent of taxable payroll until about 2044. After that date, they would rise fairly quickly, reaching 0.25 percent in about 2055, 0.40 percent in 2063, until additional costs exceed additional revenues after 2068.

Thus, while the mandatory coverage of newly hired SLGWs would provide valuable additional revenue that would allow policy makers more time to fully address Social Security's financial challenges, it is not a substitute for a carefully considered reform plan that includes other elements.

B. Equity Issues

From an equity standpoint, SLGWs who do not participate in Social Security may be acting as free riders and thus unduly benefiting in both inter- and intra-generational ways. The inter-generational concern is that Social Security enrollees are currently bearing the legacy costs of the country having greatly subsidized the first few generations of Social Security recipients. The equity argument is simply that SLGWs should face this societal obligation just like other workers do, and pay their fair share of the inherited legacy costs of Social Security (Diamond and Orszag 2005). Geanakoplos, et al. (1998) estimate that legacy costs account for about one quarter of Social Security tax revenues.

In addition, like everyone else, uncovered SLGWs receive important, but perhaps indirect, socio-economic benefits from the existence of Social Security – for example, from living in a society with lower poverty rates among the elderly and disabled than would be the case without Social Security. Unlike other workers, however, SLGWs do not pay into the system that provides these benefits. Resolution of these free rider problems is seen as a key aspect of creating a fair relationship between SLGWs and all other members of society.

In the past, there were two other ways in which state and local government employees were benefiting from the system in ways that were thought to be unfair. Both have been addressed by policy changes, but those fixes have been criticized as being poorly designed and often unfair. Covering all newly hired workers under Social Security would eliminate these issues over time.

First, the Social Security annual benefit formula is progressive, replacing a higher share of low-career-income earnings than of high-career-income earnings. But the career-income calculation takes into account the highest indexed 35 years-worth of wages, so it does not distinguish between someone who was covered by Social Security their whole career at a low wage versus someone who worked at a higher average wage but was covered by (i.e., paid into)

Social Security for only a few of those years. (Note that a worker must have paid into Social Security for a minimum of 10 years or 40 quarters in order to receive any benefits.) Thus, a worker could be employed by a state and local government whose workers are not covered by Social Security for most of his or her career, then work for 10 or more years in a job that had Social Security coverage and receive high replacement rates on the proportion of their career earnings that were covered by Social Security. The Windfall Elimination Provision, enacted in 1983, removed this possibility by creating an adjusted benefit formula for people who worked for a short period in covered employment and have a pension from other non-Social Security employment.

A second issue arose because of uncovered SLGWs who were eligible for a spousal benefit but never participated in Social Security. The Government Pension Offset was legislated in 1977 and reduces the spousal benefit by an amount equal to two-thirds of the amount of the non-covered pension (CRS 2011).

C. Recent Proposals

Virtually all Social Security and budget reform proposals over the last 20 years have proposed mandatory coverage of newly hired SLGWs. In 1997, the Social Security Advisory Council, headed by Edward Gramlich, was famously split between three proposals. One of the few things the groups agreed on was to mandate Social Security coverage for all newly hired SLGWs (Social Security Administration 1997). The National Commission on Retirement Policy (1999), a bi-partisan group of experts and lawmakers, also called for mandatory coverage of all newly hired SLGWs.

Social Security reform proposals put forth by scholars have reached vastly differing conclusions on the appropriate nature and structure of Social Security. Nevertheless, mandating coverage for new SLGWs is a widely agreed-upon feature (Aaron and Reischauer 1998, Schieber and Shoven 1999, Diamond and Orszag 2005).

Mandatory coverage of newly hired SLGWs was also endorsed by two recent bi-partisan commissions to reduce the nation's fiscal imbalances: The Bipartisan Policy Center's Debt Reduction Task Force (2010), also known as Domenici-Rivlin for its co-chairs, former Sen. Pete Domenici and Alice Rivlin, and the National Commission on Fiscal Responsibility and Reform (2010), also known as Bowles-Simpson for its co-chairs, Erskine Bowles and former Sen. Alan Simpson.

The only major commission from the last 20 years that did not endorse mandatory coverage was President George W. Bush's Commission to Strengthen Social Security (2001). Comments by Commission Co-Chair Sen. Daniel Patrick Moynihan, however, suggest that this conclusion was based more on politics than on the underlying equity or economics. He described the anti-mandatory coverage movement as politically "too strong, too organized," particularly in light of letters from 23 public pension organizations, 20 U.S. Senators, and other interested groups.[5] Nevertheless, in a New York Times op-ed, Moynihan (2000) advocated for mandatory coverage of newly hired SLGWs.

IV. Mandatory coverage, State Pensions and Budgets, and Worker Benefits

In this section, we examine several issues related to state and local pensions and Social Security. First, we provide evidence on the relationship, at the state level, between Social Security coverage of SLGWs, on the one hand, and state pension funding status and benefit levels, on the other. Then, we consider how mandating Social Security coverage would affect

[5] National Conference of State Legislatures et al. (2001), Voinovich and Feinstein et al. (2001), Coalition to Preserve Retirement Security (2001).

the benefits paid to SLGWs and the costs to employees and governments. Finally, we discuss the constitutionality of mandating coverage and describe the opposition of certain SLGW groups and governments to mandated coverage.

A. Pension Funding, Pension Benefit Levels and Social Security Coverage

Table 1 reports information on SLGW coverage under Social Security. As shown in the first two columns, as of 2008, about 27.5 percent of all SLGWs were not covered by Social Security in their current job. Some of these workers are or will be eligible for Social Security benefits, either by virtue of a prior job or spousal benefits. Coverage rates vary dramatically by state. Virtually no SLGWs are covered by Social Security in Ohio and Massachusetts, while in five other states – Nevada, Louisiana, Colorado, California, and Texas – coverage rates are below 50 percent.

The third and fourth columns report the number of uncovered workers in each state. About 6.5 million SLGWs lacked Social Security coverage on their job in 2008. The largest concentration was in California, which accounted for more than one-fifth of all affected workers nationally. Three states – California, Texas, and Ohio –account for almost half of all uncovered workers. When Massachusetts, Illinois, Colorado, and Louisiana are added to those three, the seven states account for about 70 percent of all uncovered SLGWs (CRS 2011).

1. Pension Funding Levels and Coverage

Unsustainable public pension plans put retiree income at risk. As public pension plan assets are depleted, SLGWs may lose some of their retirement benefits, particularly in extreme cases where municipalities or counties declare bankruptcy. It may only be in the rare extreme cases that accrued benefits will be reduced. But it may be far more routine for net prospective benefits to be cut through a combination of COLA reductions or freezes, employee contribution increases, or wholesale reductions for new employees.

For example, the National Conference of State Legislatures (2013, 2012, 2010, 2009) found that in 48 out of 50 states, benefits were cut back in at least some form for at least some workers. According to Sawchuk (2013), these changes frequently featured increased contributions, age, or service requirements or of benefit reduction. Munnell et. al (2013) find that in the recent public pension crisis, most state-administered pension plans examined cut back on benefits.[6]

To the extent that the states with higher levels of underfunding are also the states where fewer SLGWs are covered by Social Security, extending Social Security coverage would be particularly beneficial in that it would help protect workers who, other things equal, face the biggest risks to their state or local pension income.

To pursue this idea, we report – here and in the Appendix – several different measures of state funding ratios and plot them against SLGW coverage rates. None of the measures of pension funding is perfect. They are constructed in different ways with accordant strengths and weaknesses, reflecting ongoing differences in the field in how to treat risk, rates of return, retirement patterns, and other factors. Yet, as discussed below and shown in the Appendix, all of the measures show similar correlation with SLGW coverage rates.

For example, Figure 1 plots data on state pension funding ratios as of 2012 (from State Budget Solutions 2013), and the SLGW Social Security non-coverage rate as of 2008 (from CRS 2011). We emphasize that Figure 1, as well as Figures 2-4, combine data from different sources and different years. We also emphasize that, although we have plotted a regression line, we are

[6]See Gotbaum (2014) for discussion of why pensions are unlikely to be cut back substantially in municipal bankruptcy cases. Munnell, Aubry and Sanzenbacher (2014) argue that relatively generous pensions help state and local governments to recruit and keep high quality workers, and that rather than cutting such pensions, a better strategy might be to shift more of the financing to the employees.

not in any way implying or even suggesting a causal relationship between the two variables. Rather, we are simply looking at the association between the two and using the regression line as a convenient way to summarize the data.

Figure 1 shows that states with higher rates of uncovered workers also tend to have lower funding ratios (assets / liabilities) for their pensions. Across states, a 1 percentage point increase in the share of SLGWs that are not covered is associated with a 0.07 percentage point decrease in funding ratio. (These findings are marginally statistically significant, with a p-value of 0.085.) These results suggest a positive correlation between states that have underfunded pension plans and states where a high share of SLGWs are not covered by Social Security.

To be clear, the goal here is simply to demonstrate that underfunding is a more significant problem in states where fewer workers are covered by Social Security. Even if funding levels were about the same in states with more or less SLGW coverage, but were low across all states, there would still be a more acute retirement security problem for SLGW workers in states where fewer workers were covered by Social Security.

Figure 2 plots data on state pension underfunding as a share of gross state product (GSP) as of 2012 and the SLGW Social Security non-coverage rate in 2008. Dividing pension underfunding by GSP gives a measure of the costs relative to a state's ability to pay. Figure 2 shows that states with higher rates of uncovered workers also tend to have higher rates of unfunded liabilities as a share of GSP. Across states, a 1 percentage point increase in the share of SLGWs that are not covered is associated with an increase in unfunded liabilities by about 0.14 percentage points of GSP (p-value = 0.008).) These results suggest that there is a positive correlation between states that have high unfunded liabilities as a percentage of GSP and states where a high share of SLGWs are not covered by Social Security.

Figure 3 plots data on state pension underfunding as of 2012, as a share of annual tax revenue and the SLGW Social Security non-coverage rate as of 2008. It thus provides an alternative way to scale underfunding levels relative to a measure of ability to pay. Figure 3 shows that states with higher rates of uncovered workers also tend to have higher rates of unfunded liabilities as a share of annual tax revenue. Across states, a 1 percentage point increase in the share of SLGWs that are not covered is associated with an increase in unfunded liabilities by about 3.7 percentage points of annual tax revenue (p-value < 0.001). These results suggest that there is a positive correlation between states that have high unfunded liabilities as a share of annual tax revenue and states where a high share of SLGWs are not covered by Social Security.

In Figures 1-3, we use data from SBS (2013) on the state government pension status. Measuring pension status, however, can be complex, and so in Appendix Figures 1-3, we replicate the same analysis, with the same conclusions, using pension funding data from Pew (2014). Appendix Figures 4-6 replicate the analysis in Figures 1-3 using pension data from Novy-Marx and Rauh (2009), again with the same conclusions.

2. Pension Benefit Levels and Coverage

The second retirement-security-related question we address is the extent to which the overall generosity of pension benefits compensates for lack of Social Security coverage. To the extent that they do not, mandatory coverage would be particularly beneficial as it would be helping those with lower or average state pension benefits.

There is some evidence that public sector pensions are more generous that private sector pensions, at least for workers who spend an entire career with a single employer (Beshears et. al 2011, Biggs 2014). Beshears et. al (2011) also report evidence of significant heterogeneity across states in the generosity of their defined benefit plans. Brown, et. al (2011) report that "in some states public employees are not covered by Social Security and this explains much of the difference in [defined benefit plan] generosity" across those states. Schieber (2011) notes that government employers in general have successfully offset lower wages with generous benefits, and suggests that benefits in the public sector may even be generous enough to make overall compensation greater there than in the private sector. He also shows that a higher Social Security coverage rate among SLGWs is associated a lower replacement rate in public pension plans. We provide further evidence on the link between pension generosity and Social Security below.

Developing a full measure of pension generosity is difficult. It would require data about the annual benefit (itself a combination of benefit accrual rates and years of service), the retirement age, COLA provisions, and employee contributions. An ideal measure might be the expected net present value of benefits upon workplace entry. Unfortunately, this level of detail is unavailable for most states, and in its absence, we use different proxies.

For example, Figure 4 plots data by state on the annual pension benefit that would be received by a full-career government worker retiring in 2011 or 2012 (from Biggs 2014) and the SLGW Social Security non-coverage rate as of 2008 (from CRS 2011). As with Figures 1-3, we emphasize that Figure 4 combines data from different years and different sources and that the regression line is meant to help summarize the data, not ascribe causality. Figure 4 shows that states with higher shares of uncovered workers tend to have higher overall state pension benefits. Each percentage point in increase in share of SLGWs that are not covered is associated with an increase in predicted annual retirement benefits for a full-career worker of about $170 (p-value = 0.008).

These results are consistent with data from Munnell (2005), who reports evidence that benefit accrual rights are generally higher for state and local government pension plans in states where a small share of SLGWs are covered by Social Security. Given the pension underfunding in certain jurisdictions and the potential that this could cause benefit reductions, there is some question as to the extent to which the increased level of promised benefits compensates for the risk of benefit cuts and the absence of Social Security coverage.

Moreover, it is critical to note that the data in Figure 4 apply to full-career government workers. Many employees of state and local governments do not stay in the job long enough to receive any vested pension benefits. Vesting periods are generally longer in state and local government plans than in private sector defined benefit plans (Johnson et. al 2014). Moreover, even after having been vested, workers must work for significant periods just to receive benefits as large as their own contributions. "In half of the traditional plans administered by state governments, employees must work at least 20 years before accumulating any employer-financed pension benefits" (Johnson et. al 2014). Benefit accrual schedules for SLGWs tend to be highly "back-loaded" in favor of career employees. For all of the reasons, coverage under Social Security, where accrual patterns are more uniform across the course of a career and where benefits are portable, would be particularly valuable for a large swath of SLGWs.

B. Improving Retirement Benefits

Providing Social Security to newly hired SLGWs would improve their retirement benefits in several ways. Most obviously, it could raise the security of retirement income by diversifying its sources. One could argue that since Social Security is underfunded – and hence faces potential benefit cuts and/or payroll tax increases – the addition of SLGWs to Social Security would simply shift risks, but the fact that risks faced by the two types of systems are quite different suggests rather a reduction in overall retirement risk. Workers who are enrolled in an underfunded state or local government pension plan face retirement income risks. Those who are also not covered by Social Security may have little to fall back on, should their government pension be reduced. Including public employees in Social Security would diversify the sources of retirement income and improve their retirement security.

As noted above, this is particularly an issue because many state and local governments require employees to have at least 5 years of service in order to qualify for any pension, and far longer service to receive more than their own contributions. Further, state and local employees who transfer to another jurisdiction may not receive credit for their previous service. This would be especially true for uncovered SLGWs who are not employed long enough to qualify for a state or local pension. As Social Security benefits are calculated using the highest 35 years of indexed earnings upon which payroll taxes have been paid, these employees will receive no benefit for the years they worked without Social Security coverage, and either have a benefit that includes lower earning years or one that is calculated using less than the required number of years needed for a full benefit. This situation especially affects public school teachers. It is estimated that only half of teachers work long enough to qualify for a public pension (Kan and Aldeman 2014), and as noted above, teachers have low rates of Social Security coverage.

Mandated coverage would also raise the quality of benefits provided. Social Security provides an inflation-adjusted annuity, along with survivors' and disability insurance. State and local government pensions, generally, are imperfectly indexed for inflation and provide less generous survivor benefits and disability benefits.

Benefit levels and benefit quality are related, of course. As discussed below, if, in response to mandatory coverage, state and local governments reduced pensions so that first-year benefits under a social-security-and-pensions system equaled first-year benefits under the current system, lifetime benefits under the social-security-and-pension system would be higher than under the current system because of the extra protections that Social Security provides.

C. Costs

Social Security coverage of newly hired SLGWs in systems that are not already part of the program would raise costs for both the employees and their employers by requiring both to pay their share of the program's payroll taxes. Qualitatively, the problem with adding the cost of payroll taxes applies mainly to state and local systems that are already underfunded, and thus in need of additional revenue from either the sponsoring governments or the employees to pay existing benefit promises. Because payroll taxes are sent to the federal government, adding Social Security coverage would increase retirement costs without having any immediate positive effect on the funding status. This is in part due to the fact that the payment of Social Security premiums would start immediately, but any reduction in state pension costs (see below) would only come in the future. Further, Social Security's own underfunding could result in higher payroll taxes in the future, which would further increase costs for state and local governments and employees. And, finally, for states where the constitution forbids reduction in benefits – like Illinois[7] – adding Social Security would raise costs by the full amount of the employer payroll tax, and stretch an already thin budget.

Quantitatively, the extent to which employment costs would rise depends on the extent to which state and local governments adjust their overall pension benefits in response to the coverage of new hires. Simply adding Social Security coverage to existing retirement benefit plans would result in more expensive benefit packages because those workers would receive both Social Security benefits and the full amount of previously promised pensions. Therefore, affected state and local governments are likely to adjust the overall size of their retirement

[7] Unless current challenges to that constitutional protection are successful.

packages so that the combination of the two elements equals the total size of todays promised benefits. While this approach would eventually lower the cost to state and local governments since they would only be responsible for the benefits above those paid by Social Security, those cost savings would occur several decades in the future while the payroll taxes would need to be paid starting immediately.

An important difference between state and local pension plans and the Social Security trust fund is that the pension plans can invest in private stocks and bonds, while the trust fund can only invest in Treasury securities. Depending on one's views about the source and nature of the equity premium, this difference may allow pensions to earn a higher risk-adjusted return on their portfolios, which would in turn allow them to offer a better benefit at lower cost even in the absence of legacy cost issues.

Munnell, Aubry, and Belbase (2014) find that mandating coverage for newly hired SLGWs would increase costs for new hires by between 5 percent and 13 percent of payroll, depending on how states adjust their own pensions. One response to mandated coverage would be to preserve retirees' first-year benefits; that is, to ensure that the combination of defined pension benefits and Social Security benefits for workers' first year of retirement would be equal to what he or she would have received under the current system without mandatory coverage. This response would increase costs for new hires by about 6 percent of payroll for new hires or, in the next five years, by about 0.15 percent of state budgets. The latter figure is so low because payroll is only one part of state government budgets, new hires are a small fraction of total labor costs, and payroll taxes are a small fraction of the costs of new hires. Over time, as the labor force turns over and a greater proportion of the workforce is covered, costs would rise to around 0.9 percent of state budgets. The scenario that provides equal first-year benefits actually provides SLGWs with higher expected *lifetime* benefits than would be received under their current plans, because Social Security is fully indexed for inflation and provides superior dependent, survivor, spousal, and disability benefits than many state and local pensions do (CRS 2011).[8] Costs are likely to be higher as a share of local government budgets than of state government budgets because labor costs are a bigger share of local budgets.

In addition to higher payroll taxes, coverage would raise administrative costs. Maintaining separate program rules for new hires with Social Security and existing employees without it would add to administrative costs. However, it appears that most of the administrative costs would involve setting up new systems rather than continuing costs, and in neither instance is it clear that those costs would be very large. The GAO (1998) estimated that a full transition to full Social Security coverage would only take a few years.

D. Constitutional Issues

As noted earlier, the stated reason that SLGWs were not covered by Social Security in the initial 1935 Social Security legislation concerned the constitutionality of the federal government taxing state governments. However, this question seems to have been resolved for some time, and it appears that the federal government does have the power to mandate the coverage of both newly hired and other SLGWs.

Many Social Security commissions and experts have weighed in with the view that mandatory coverage would be constitutional. The 1994-6 Social Security Advisory Council wrote, "In the light of several Supreme Court decisions dealing with Federal/State relationships

[8] Mandating coverage and adjusting pensions so that lifetime Social Security and pension benefits were the same as pension benefits would be under the current system would result in a cost increase of about 5 percent of payroll for new hires and, in the long run, up to 0.8 percent of state budgets. The reason why costs would go up even though lifetime benefits would not has to do with the legacy and redistribution costs of Social Security.

in the area of labor law, it is now generally thought that there is no Constitutional barrier to compulsory coverage." GAO (1998) noted their view that mandatory coverage is constitutional. Likewise, Aaron and Reischauer (1998) say that "State and local governments have never been required to participate in Social Security. Initially, legal experts doubted whether the Constitution permitted the federal government to force their participation. Although most experts now believe such a power exists, the federal government has not exercised it."

Moreover, in many cases, it appears that the federal government has already mandated that state governments cover the cost of payroll taxes without a constitutional challenge. In 1983, Congress made Social Security participation irrevocable for state and local governments. Thus, if they participated at the time, they must continue to participate even if they would prefer to leave the system at a later date. Starting in 1986, all newly hired SLGWs were required to enroll in Medicare, with states paying the employer portion of its payroll tax. Finally, in 1990 Congress required that states that did not have a retirement plan would have to enroll their workers in Social Security. In all of these examples, the federal government imposed employer payroll taxes on state and local governments.

E. Opposition by Certain State and Local Workers and Governments

Just as there is strong support in the Social Security community for mandatory coverage for newly hired SLGWs, there is widespread opposition to the idea among state and local government workers and governments. The American Federation of State, County & Municipal Employees; Fraternal Order of Police; International Association of Fire Fighters; International Public Management Association for Human Resources; National Conference of State Legislatures; National Education Association; and many other organizations representing SLGWs and state and local governments have expressed the view that Social Security coverage should not be mandatorily extended to SLGWs.[9]

Their major concern is the added costs involved, as well as fears that modifying existing pension plans to allow a base level of benefits to be paid by Social Security would also open the door to a reduction of total benefits or even a complete pension overhaul where a defined contribution or hybrid system would be substituted for an existing traditional defined benefit system. In addition, as noted above, a pension system that invests in private assets would, historically, have received a higher risk-adjusted rate of return than Social Security, which invests in solely in federal government bonds. Some models assume that this difference will persist in the future. For all of these reasons, as well as legacy costs, many state and local workers and governments do not see joining the Social Security program as a good deal for themselves.

Interestingly, most federal workers opposed a shift from the Civil Service Retirement System to the Federal Employee Retirement System (FERS) in the mid-1980s. Only 4 percent of those who had the opportunity to change to the new plan chose to do so. Recent surveys, however, show that FERS is extremely popular with federal employees (OPM 2013).

V. Conclusion

Social Security coverage for newly hired SLGWs would provide a number of benefits to the employees themselves in addition to helping to solve a number of other problems. First and most important to the affected workers, the coverage would improve retirement security for SLGWs, many of whom are enrolled in pension plans that are significantly underfunded and all

[9] American Federation of State, County, and Municipal Employees (1998), Canterbury (2008), International Association of Fire Fighters (2012), International Public Management Association for Human Resources (1999), National Conference of State Legislatures (2014), National Education Association (2005).

of whom are enrolled in plans that are not very portable. This is especially true for those currently uncovered SLGWs who leave government service before qualifying for a pension. Currently, these workers may have nothing to show in terms of retirement benefits for their years of service, but with coverage, they will at least have continued to build a Social Security earnings record. For those who do qualify for a pension, coverage would likely raise the level of retirement benefits, even assuming that state and local governments would cut back their own pensions to some extent. And, importantly, it would improve the quality of retirement benefits for SLGWs, as Social Security offers inflation-indexed annuities along with survivor and disability benefits, a package of benefits that is often superior to what SLGWs obtain currently.

In addition, coverage would improve Social Security's finances over the next several decades. It would also be more equitable on both inter- and intra-generational grounds by ensuring that everyone who benefits from the existence of a social safety network would actively "buy into" the system.

Coverage would add to employer and perhaps to employee costs – largely through payroll taxes but also due to temporary administrative burdens. As noted, these would be relatively small compared to overall state budgets but given some states' overall budget situation in general and pension underfunding in particular, these costs could be politically significant.

It is important to note that workers would very likely shoulder most or all of the resultant increase in payroll taxes, but of course they would receive the added retirement benefits as well. It is true that workers in certain specific occupations, such as fire fighters and police officers, may find the one-size-fits-all approach of Social Security to be unsatisfactory compared to existing, profession-specific pension programs, and their concerns should be taken into consideration.

While almost all Federal commissions on Social Security or the federal budget, and virtually all Social Security reform plans have endorsed Social Security coverage for newly hired SLGWs, there is strong opposition among SLGW groups and state governments. Thus, policy makers face both political divides and economic trade-offs in resolving these issues.

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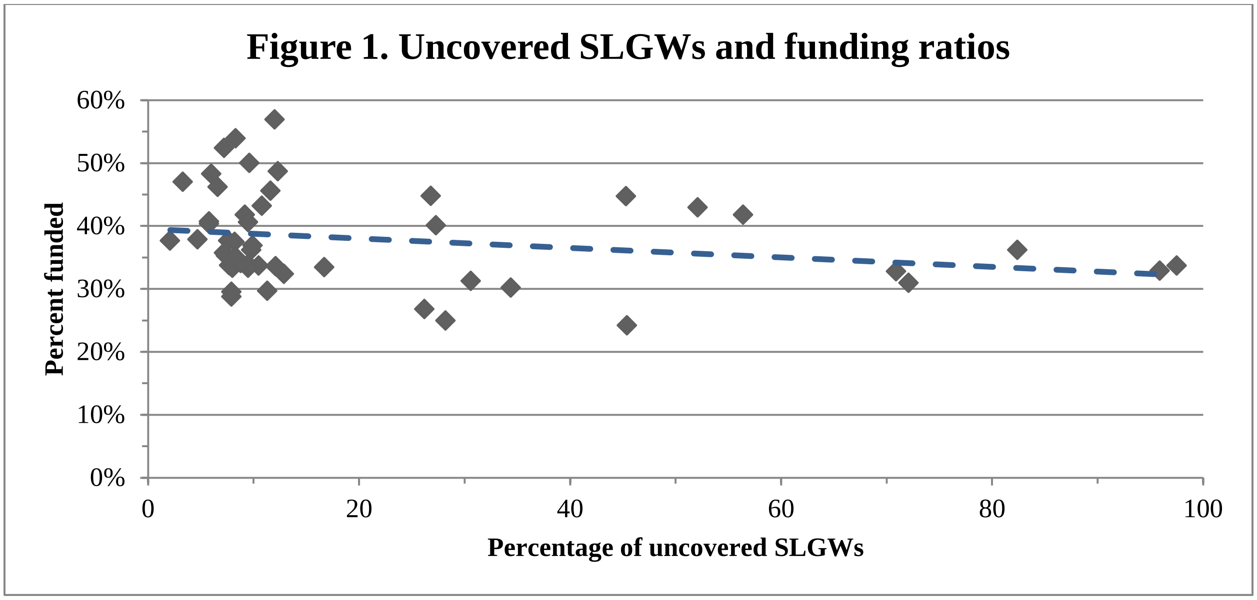
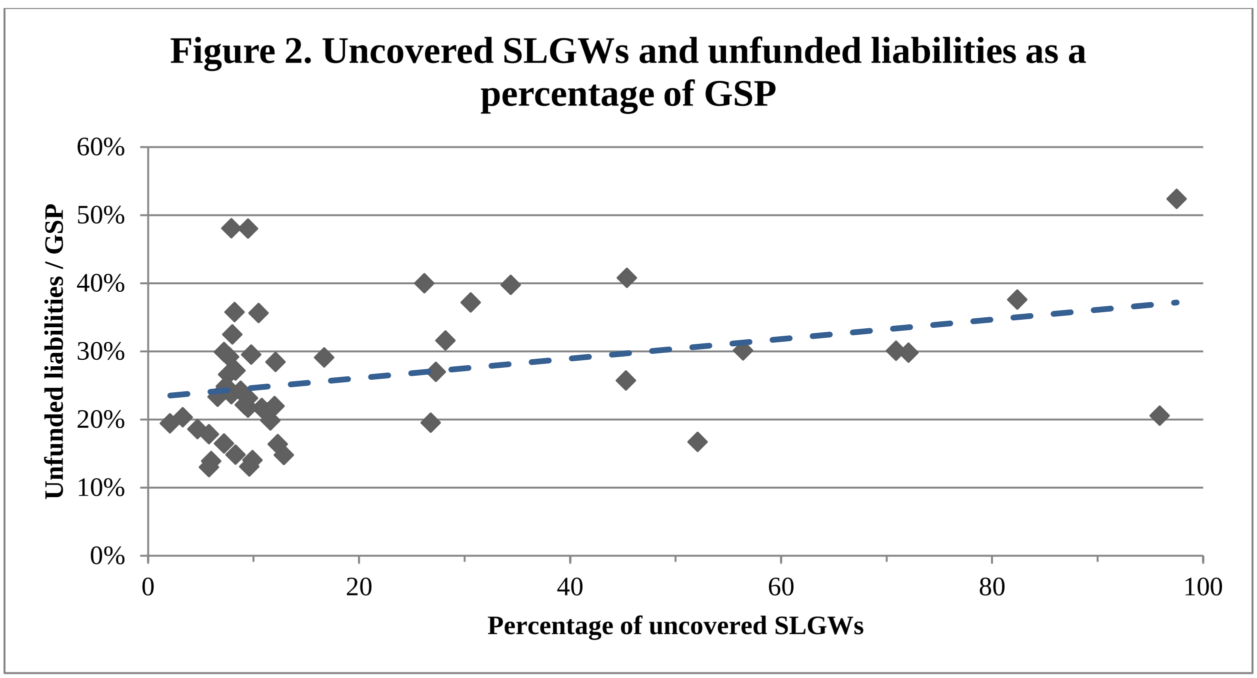
Table 1. Top 10 states by alternate measures of non-coverage in 2008

State	Percentage of uncovered SLGWs	State	Number of uncovered SLGWs
Ohio	97.5	California	1,405,500
Massachusetts	95.9	Texas	939,000
Nevada	82.4	Ohio	827,900
Louisiana	72.1	Massachusetts	459,400
Colorado	70.9	Illinois	441,000
California	56.4	Colorado	297,700
Texas	52.1	Louisiana	233,100
Illinois	45.4	Georgia	188,500
Maine	45.3	Florida	131,900
Alaska	34.4	Nevada	97,300
Total (mean):	**27.5**	**Total:**	**6,550,800**

Source: CRS (2011)

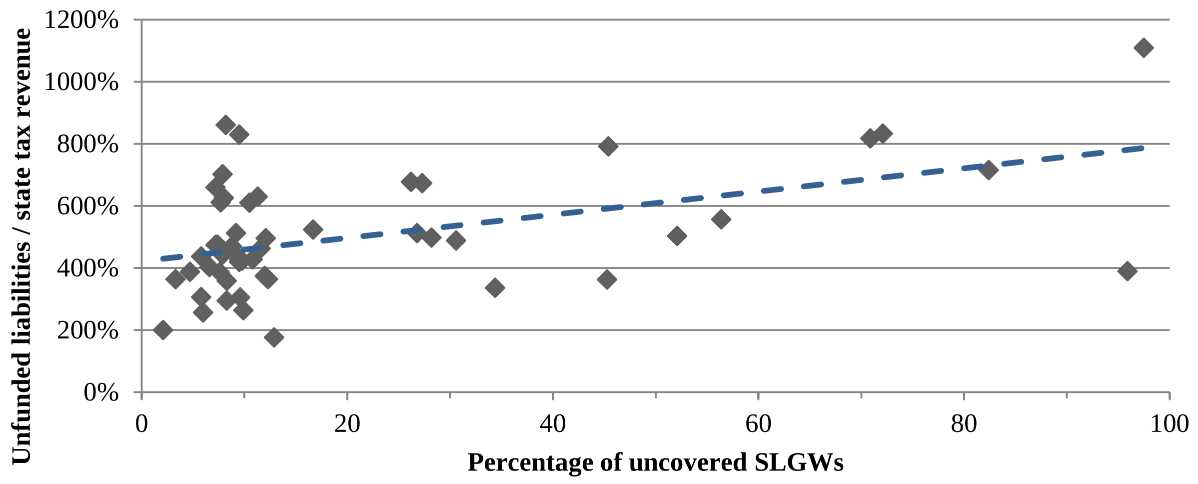


Source: Data for percentages of uncovered SLGWs from CRS (2011). Data on funding ratios from SBS (2013).



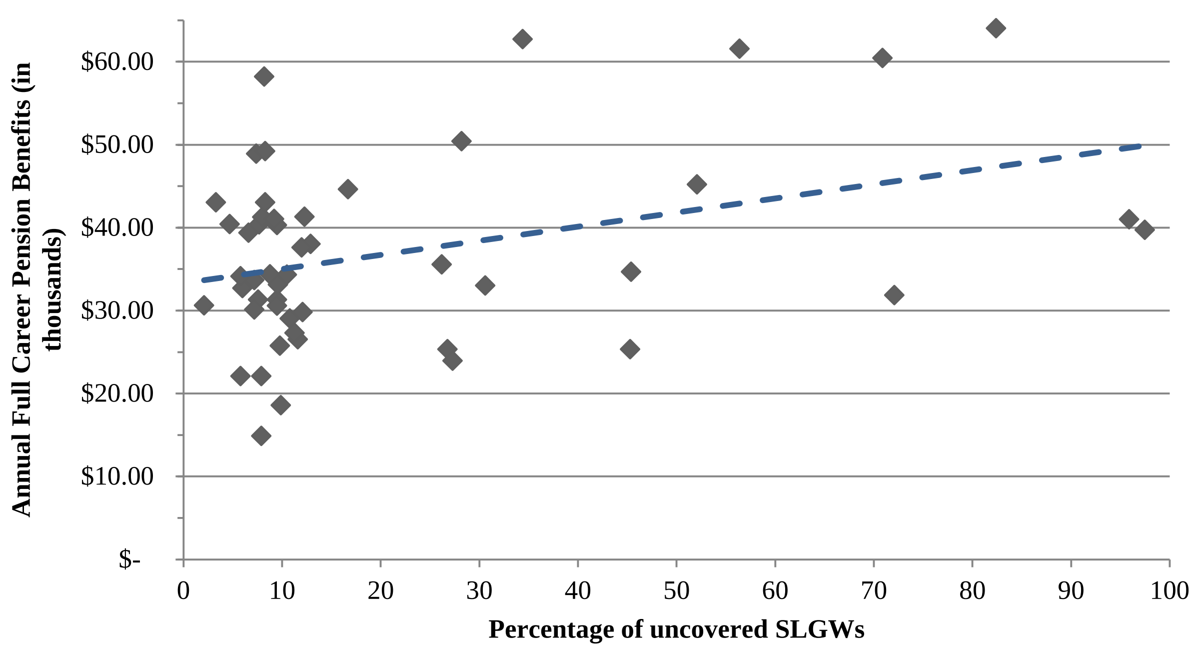
Source: Data for percentages of uncovered SLGWs from CRS (2011). Data on unfunded liabilities from SBS (2013). Data on GSP from BEA (2014).

Figure 3. Uncovered SLGWs and unfunded liabilities as a percentage of state tax revenue



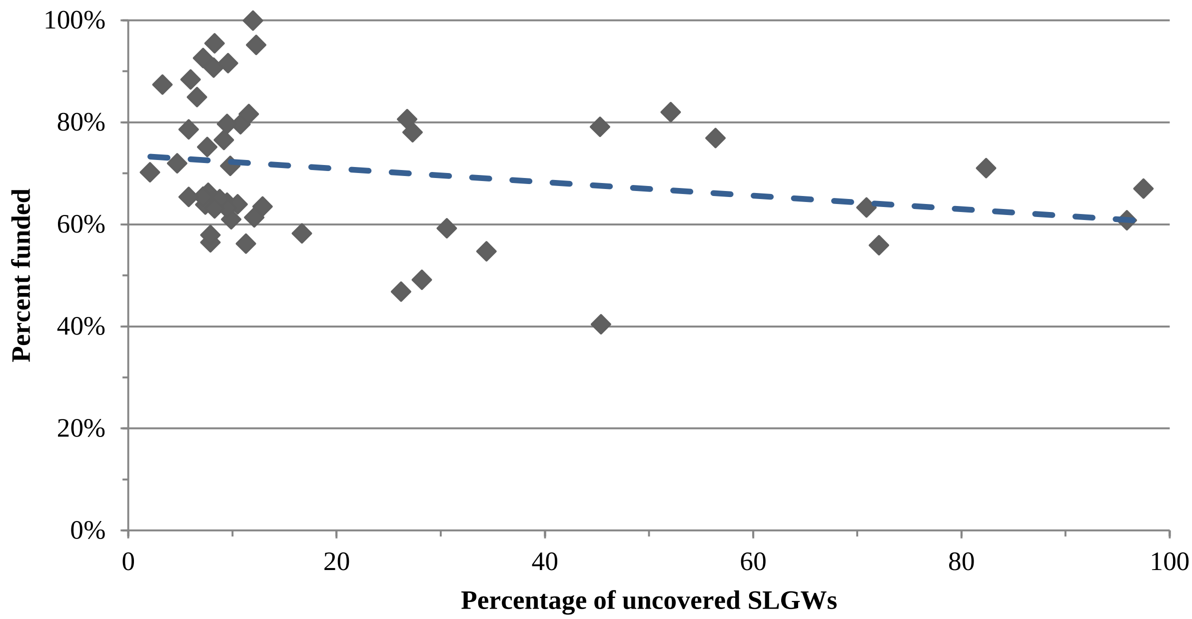
Source: Data for percentages of uncovered SLGWs from CRS (2011). Data on unfunded liabilities from SBS (2013). Data on state tax revenue from Census (2013).

Figure 4. Uncovered SLGWs and state pension benefits



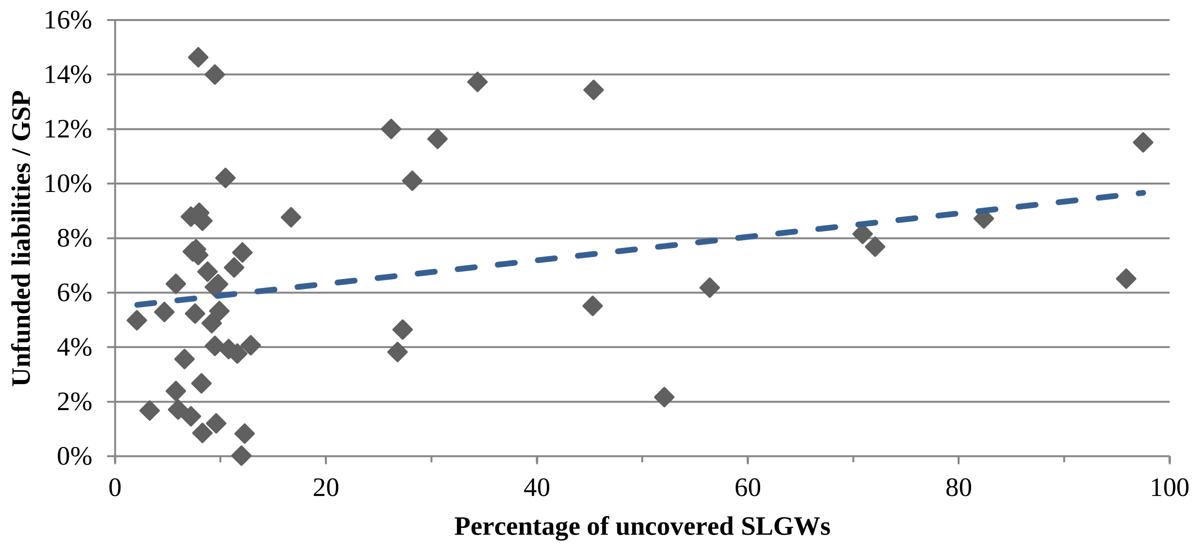
Source: Data for percentages of uncovered SLGWs from CRS (2011). Data on state pension benefits from Biggs (2014).

Appendix Figure 1. Uncovered SLGWs and funding ratios

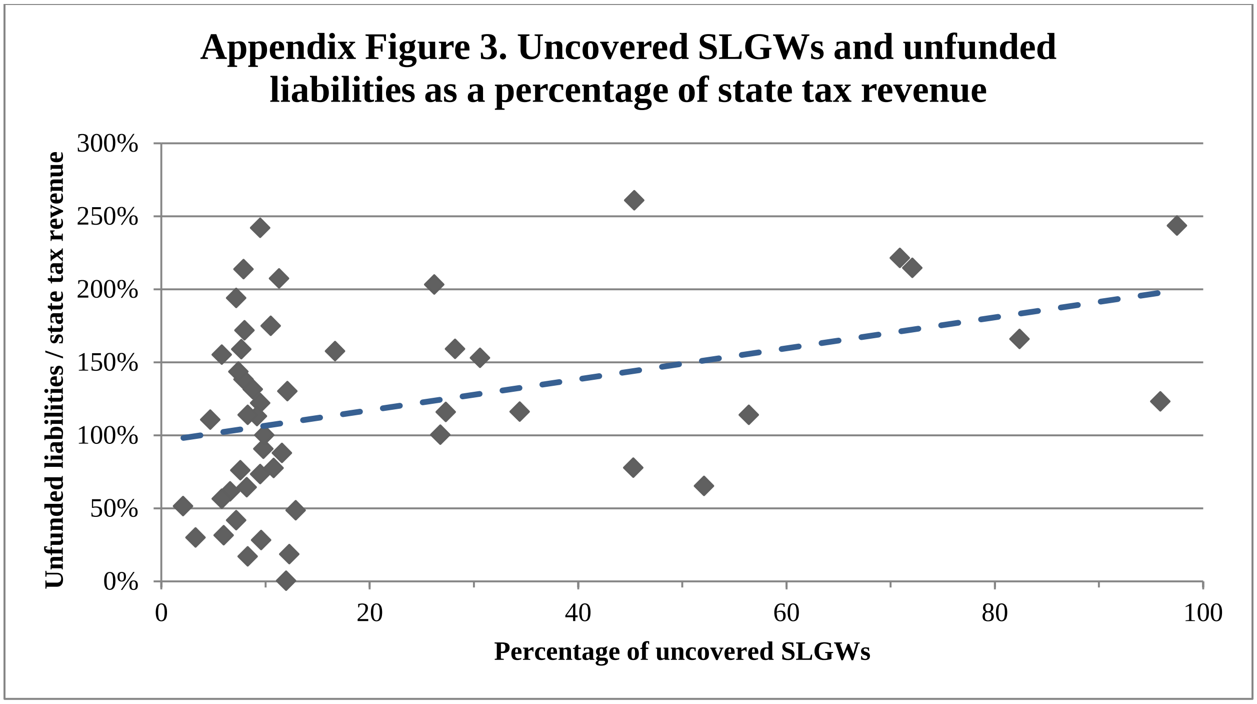


Source: Data for percentages of uncovered SLGWs from CRS (2011). Data on funding ratios from Pew (2014).

Appendix Figure 2. 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 Pew (2014). Data on GSP from BEA (2014).



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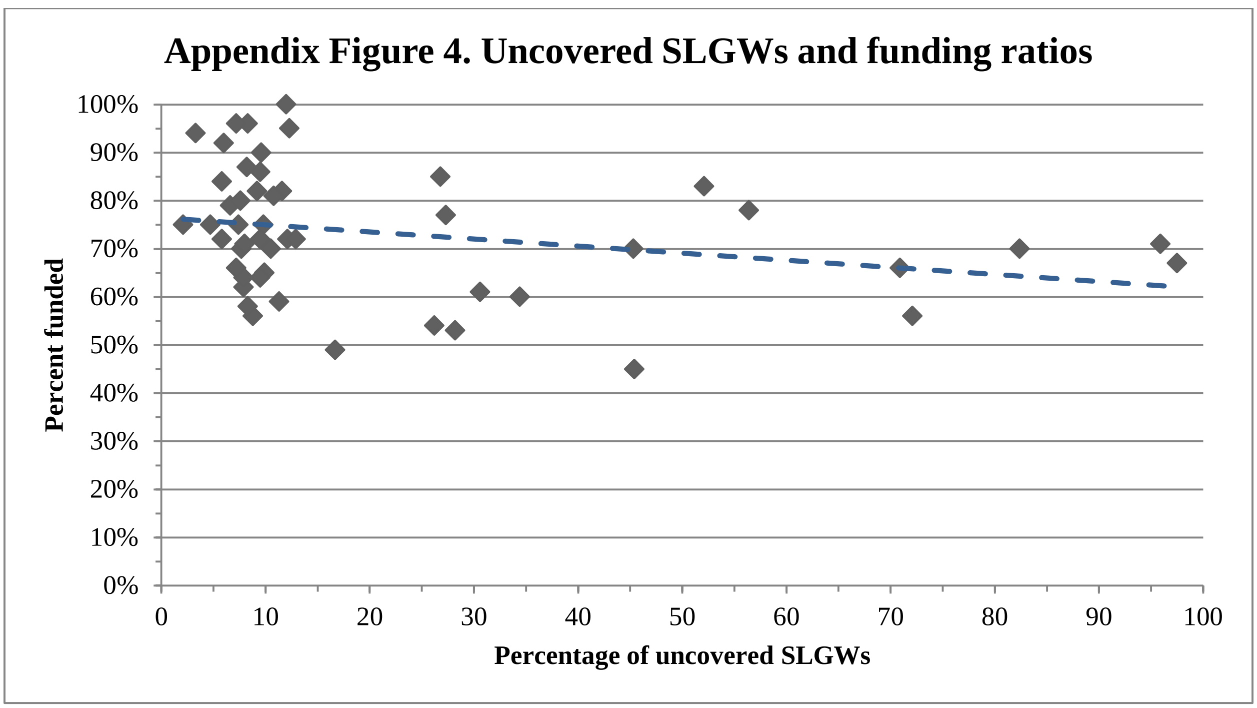
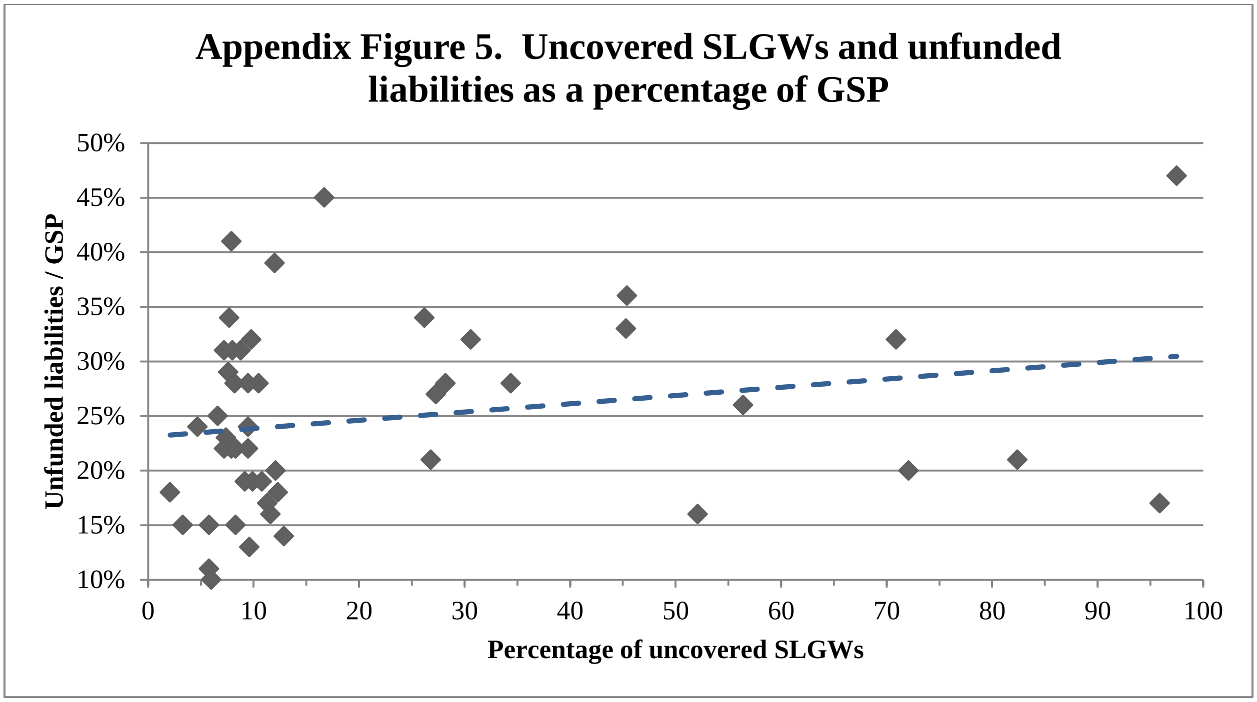


Source: Data for percentages of uncovered SLGWs from CRS (2011). Data on unfunded liabilities from Novy-Marx and Rauh (2009).



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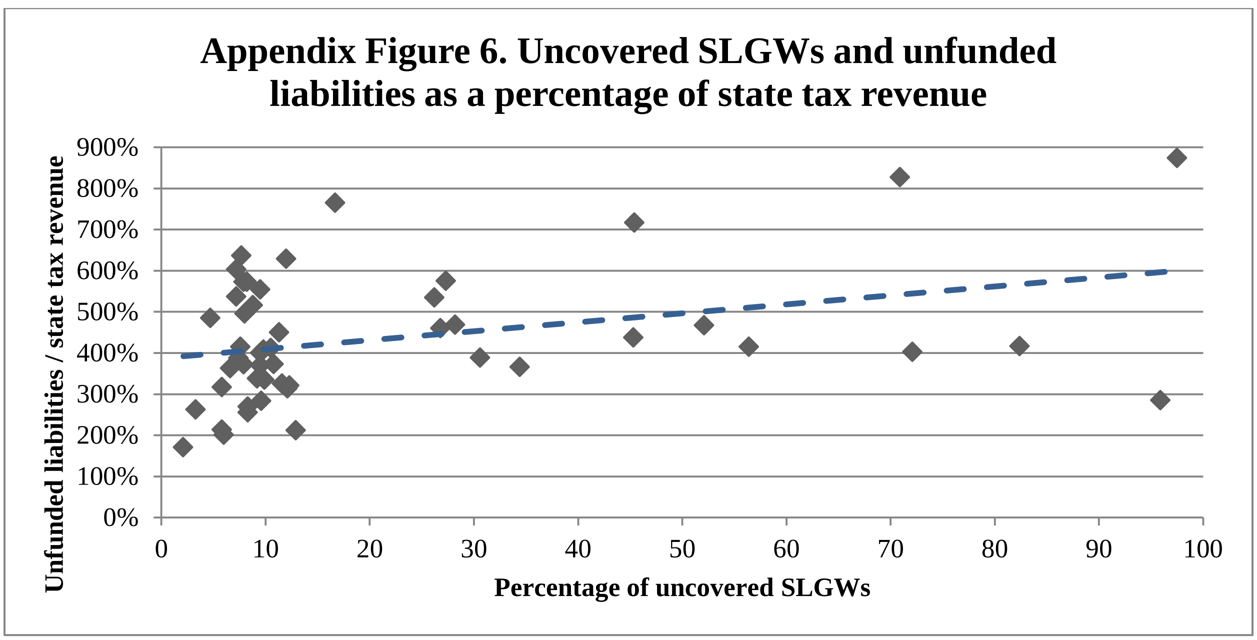

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