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SOCIAL SECURITY

Mandating Coverage for State and Local Employees

Statement of Cynthia M. Fagnoni, Director
Income Security Issues
Health, Education, and Human Services Division

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Social Security: Mandating Coverage for State and Local Employees

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me to testify on extending mandatory Social Security coverage to all newly hired state and local government employees. Currently, the Social Security Administration (SSA) estimates that about 30 percent—or about 5 million employees—of the state and local workforce is not covered by Social Security. As you are aware, SSA projects Social Security revenues to fall short of expenditures starting in 2021 and the trust funds to be exhausted by 2032. To offset a part of the financial shortfall, the 1994-1996 Social Security Advisory Council favored extending mandatory coverage to all newly hired state and local government workers.

Today, I would like to focus on the implications of mandating such coverage for the Social Security program, public employers, newly hired employees, and the affected pension plans. I will also address potential legal and administrative issues associated with implementing mandatory coverage. My testimony is based on work we are currently conducting for the Chairman of this Subcommittee.

In summary, our work shows that mandating coverage for all newly hired public employees would reduce Social Security's long-term financial shortfall by about 10 percent, increase participation in an important national program, and simplify program administration. The impact on public employers, employees, and pension plans would depend on how states and localities with noncovered employees would react to these new coverage provisions. One often-discussed option would be for public employers to modify their pension plans in response to mandatory Social Security coverage. We will focus on this option. For example, many public pension plans currently offer a lower retirement age and higher retirement income benefit than Social Security. Social Security, on the other hand, offers complete inflation protection, full benefit portability, and dependent benefits, which are not available in many public pension plans. Costs would likely increase for those states and localities that wanted to keep their enhanced benefits for newly hired employees. Alternatively, states and localities that wanted to maintain level spending for retirement would likely need to reduce some pension benefits. Regardless, mandating coverage for public employees would present legal and administrative issues that would need to be resolved. For example, states and localities could require up to 4 years to design, legislate, and implement changes to current pension plans.

Background

The 1935 Social Security Act mandated coverage for most workers in commerce and industry, which at that time comprised about 60 percent of the workforce. State and local government employees were excluded because they had their own retirement systems and there was concern over the question of the federal government's right to impose a tax on state governments.

Subsequently, the Congress extended mandatory Social Security coverage to most of the excluded groups, including state and local employees not covered by a public pension plan. The Congress also extended voluntary coverage to state and local employees covered by public pension plans. Since 1983, however, public employers have not been permitted to withdraw from the program once they are covered. SSA estimates that 96 percent of the workforce, including 70 percent of the state and local government workforce, is now covered by Social Security.

Social Security provides retirement, disability, and survivor benefits to insured workers and their dependents. Insured workers are eligible for full retirement benefits at age 65[1] and reduced benefits at age 62. Social security retirement benefits are based on the worker's age and career earnings, are fully indexed for inflation after retirement, and replace a relatively higher proportion of the final year's wages for low earners. Social Security's primary source of revenue is the Old Age, Survivors, and Disability Insurance portion of the payroll tax paid by employers and employees. The payroll tax is 6.2 percent of earnings each for employers and employees, up to an established maximum.

SSA estimates that 5 million state and local government employees, excluding students and election workers, are not covered by Social Security. SSA also estimates that annual wages for noncovered employees total about $132.5 billion. Seven states—California, Colorado, Illinois, Louisiana, Massachusetts, Ohio, and Texas—account for more than 75 percent of the noncovered payroll. A 1995 survey of public pension plans found that police, firefighters, and teachers are more likely to occupy noncovered positions than other employees.

Most full-time public employees participate in defined benefit pension plans. Minimum retirement ages for full benefits vary; however, many state and local employees can retire with full benefits at age 55 with 30 years of service. Retirement benefits also vary, but they are usually based on a

[1]Beginning with those born in 1938, the age at which full benefits are payable will increase in gradual steps from age 65 to age 67.

specified benefit rate for each year of service and the member's final average salary over a specified time period, usually 3 years. For example, plans with a 2-percent rate replace 60 percent of a member's final average salary after 30 years of service. In addition to retirement benefits, a 1994 Department of Labor survey found that all members have a survivor annuity option, 91 percent have disability benefits, and 62 percent receive some cost-of-living increases after retirement.

As part of our study, we examined nine state and local defined benefit plans covering over 2 million employees. For those plans, employer contributions ranged from 6 to 14.5 percent of payroll and employee contributions ranged from 6.4 to 9.3 percent of payroll. (See the appendix.)

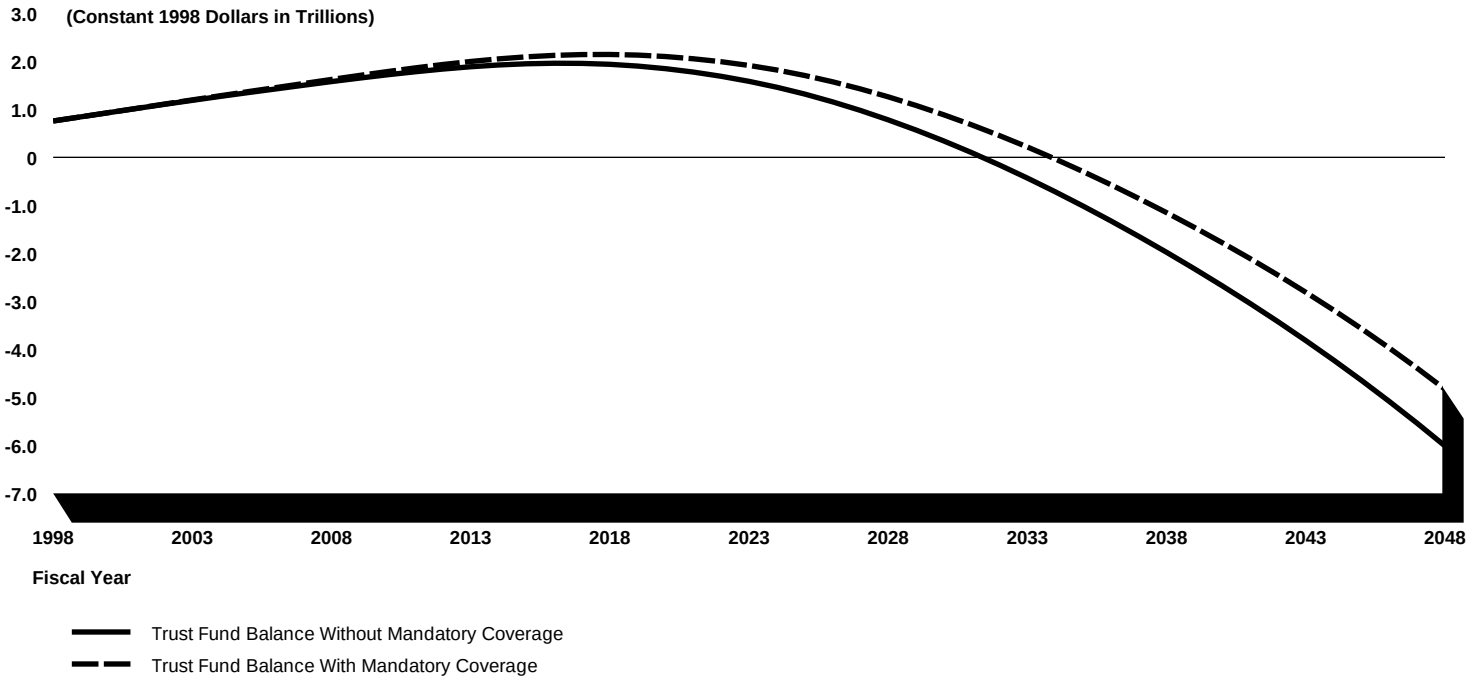
Mandatory Coverage Would Benefit the Social Security Program

Extending mandatory Social Security coverage to states and localities with noncovered workers would reduce the trust funds' long-term financial shortfall, increase program participation, and simplify program administration.

SSA estimates that mandatory coverage would reduce Social Security's financial shortfall by about 10 percent—from 2.19 percent of payroll (a present discounted value of $3.1 trillion) to 1.97 percent of payroll (a present discounted value of $2.9 trillion)—over a 75-year period.[2] Figure 1 shows that mandatory coverage would also extend the program's solvency by about 2 years, from 2032 to 2034. As with most other elements of the reform proposals put forward by the 1994-1996 Social Security Advisory Council, such as raising the retirement age, extending mandatory coverage to newly hired state and local employees would resolve only a part of the trust funds' solvency problem. A combination of adjustments will be needed to extend the program's solvency over the entire 75-year period.

[2]SSA uses a period of 75 years for evaluating the program's long-term actuarial status to obtain the full range of financial commitments that will be incurred on behalf of current program participants.

Figure 1: Comparison of Projected End-Of-Year Trust Fund Balances With and Without Mandatory Coverage, 1998 to 2048



Note: SSA data were based on intermediate assumptions in the 1998 Board of Trustees report. SSA assumed that mandatory coverage would be effective beginning January 1, 2000.

Source: GAO analysis of SSA data.

SSA data indicate that revenues from payroll taxes on the newly covered workers, taxes on their benefits, and interest on the added trust fund balances would substantially exceed additional expenditures throughout the 75-year period. SSA assumes that payroll tax collections for new employees would accelerate early in the 75-year period, while benefits for those employees would not rise significantly until later in the period.

While Social Security's solvency problems have triggered an analysis of the impact of mandatory coverage on program revenues and expenditures, the inclusion of such coverage in a comprehensive reform package would need to be grounded in other considerations. In recommending that mandatory coverage be included in the reform proposals, the Advisory

Council stated that mandatory coverage is basically "an issue of fairness." The Advisory Council report stated that "an effective Social Security program helps to reduce public costs for relief and assistance, which, in turn, means lower general taxes. There is an element of unfairness in a situation where practically all contribute to Social Security, while a few benefit both directly and indirectly but are excused from contributing to the program."

Mandatory coverage would also simplify program administration in the long run. SSA's Office of Research, Evaluation, and Statistics estimates that 95 percent of noncovered state and local employees become entitled to Social Security as either workers, spouses, or dependents. SSA's Office of the Chief Actuary estimates that 50 to 60 percent of noncovered employees will be fully insured by age 62 from covered employment.

The Congress has established the government pension offset and windfall elimination provisions to reduce the unfair advantage that workers who are eligible for pension benefits based on noncovered employment might have when they apply for Social Security benefits. The earnings histories for workers with noncovered earnings may appear to qualify them for the higher earnings replacement rates that Social Security assigns to lower earners, when in fact they have substantial income from public pension plans. With some exceptions, the government pension offset and windfall elimination provisions require SSA to use revised formulas to calculate benefits for workers with noncovered employment.

However, a separate GAO study for the Chairman of this Subcommittee indicates that SSA is often unable to determine whether applicants should be subject to the government pension offset or windfall elimination provisions.[3] We estimate that failure to reduce benefits for federal, state, and local employees caused $160 million to $355 million in overpayments between 1978 and 1995. In response, SSA plans to perform additional computer matches with the Office of Personnel Management and the Internal Revenue Service (IRS) to get noncovered pension data in order to ensure that these provisions are applied. Mandatory coverage would reduce benefit adjustments by gradually reducing the number of employees in noncovered jobs. Eventually, all state and local employees, with the exception of a few categories of workers, such as students and election workers, would be in covered employment.

[3]Social Security: Better Payment Controls for Benefit Reduction Provisions Could Save Millions (GAO/HEHS-98-76, Apr. 30, 1998).

Additionally, in 1995, SSA asked its Inspector General to undertake a review of state and local government employers' compliance with Social Security coverage provisions. In December 1996, SSA's Office of the Inspector General reported that Social Security provisions related to coverage of state and local employees are complex and difficult to administer.[4] The report stated that few resources were devoted to training state and local officials and ensuring that administration and enforcement roles and responsibilities are clearly defined. The report concluded that there is a significant risk of sizeable noncompliance with state and local coverage provisions. In response, SSA and IRS, which is responsible for collecting Social Security payroll taxes, initiated an effort to educate employers and ensure compliance with legal requirements for withholding Social Security payroll taxes.

Impact of Mandatory Coverage on Employers, Employees, and Their Pension Plans Would Vary

If all newly hired public employees were to receive mandated Social Security coverage, they would have the income protection afforded by Social Security. Also, they and their employers would pay the combined Social Security payroll tax of 12.4 percent of payroll. Each state and locality with noncovered workers would decide how to respond to the increase in retirement costs and benefits. They could absorb the added cost and leave current pension plans unchanged or eliminate plans completely. From discussions with state and local representatives, however, we believe states and localities with noncovered workers would likely adjust their pension plans to reflect Social Security's costs and benefits. To illustrate the implications of mandatory coverage to employers and employees, we examined three possible responses:

- States and localities could maintain similar benefits for current and newly hired employees. This response would likely result in an increase in total retirement costs and some additional benefits for many newly hired employees.
- States and localities could examine other pension plans that are already coordinated with Social Security and provide newly hired employees with similar benefits. This response would also likely increase costs and benefits for newly hired employees.
- States and localities could maintain level retirement spending. This response could require a reduction in pension benefits.

[4]Social Security Coverage of State and Local Government Employees, SSA Office of the Inspector General (A-04-95-0613, Dec. 13, 1996).

According to pension plan representatives, each of these responses to mandatory coverage would result in reduced contributions to current plans, which could affect long-term financing of the plans.

Maintaining Level Benefits Would Likely Increase Costs

States and localities with noncovered workers could opt to provide newly hired employees with Social Security and pension benefits that, in total, approximate the pension benefits of current employees. Studies indicate that such an option could increase retirement costs by 7 percent of new-employee payroll. Using SSA's data and its assumption that mandatory coverage would start January 1, 2000, a 7 percent of payroll increase in retirement costs for newly hired employees would mean additional costs to states and localities with noncovered workers of about $9.1 billion over the first 5 years.

A 1980 study of the costs of providing Social Security coverage for noncovered workers provides support for the estimated 7 percent of payroll increase. The Universal Social Security Coverage Study Group developed options for mandatory coverage of employees at all levels of government and analyzed the fiscal effects of each option. The study group used two teams of actuaries to study over 40 pension plans. The study estimated that costs, including Social Security taxes and pension plan contributions, would need to increase an average of 2 to 7 percent of payroll to maintain level benefits for current and newly hired employees.[5]

The study assumed that most newly hired employees would have salary replacement percentages in their first year of retirement that would be comparable to those provided to current employees. For example, employees retiring before age 62 would receive a temporary supplemental pension benefit to more closely maintain the benefits of the current plan. Since Social Security benefits are fully indexed for inflation and many pension plans have limited or no cost-of-living protection, total lifetime benefits for many newly hired employees would be greater than those provided to current employees. Existing pension plan disability and survivor benefits were also adjusted to reflect Social Security disability and survivor benefits.

More recent studies by pension plan actuaries in Colorado, Illinois, and Ohio also indicate the cost increase would be in that same range. For

[5]The study estimate was 5 to 10 percent of payroll. We deducted the 2.9 percent of payroll Medicare tax since it was mandated for all newly hired state and local employees in 1986, after the study was completed.

example, a December 1997 study for a plan in Ohio indicated that providing retirement and other benefits for future employees that, when added to Social Security benefits, approximate benefits for current employees would require an increase in contributions of 6 to 7 percent of new-employee payroll. A 1997 study for a pension plan in Illinois indicated the increased payments necessary to maintain similar total benefits for current and future employees would be about 6.5 percent of new-employee payroll.

The 1980 study stated that the causes of the cost increase cannot be ascribed directly to specific Social Security or pension plan provisions. The study also states, however, that certain Social Security and pension plan provisions are among the most important factors contributing to the cost increase. Social Security is fully indexed for cost-of-living increases, is completely portable, and provides substantial additional benefits for spouses and dependents. In addition, pension plans would need to provide special supplemental benefits for employees who retire before age 62, especially in police and firefighter plans.

The study also found that the magnitude of the cost increase would depend on the pension plan's current benefits. Cost increases would be less for plans that already provide disability, survivor, and other benefits similar to those provided by Social Security because those plans would be able to eliminate duplicate benefits.

Matching Pension Benefits of Currently Covered Employees Would Likely Increase Costs

About 70 percent of the state and local workforce is already covered by Social Security. If coverage is mandated, states and localities with noncovered employees could decide to provide newly hired employees with pension plan benefits similar to those provided to currently covered employees.

The 1980 study examined this option and concluded that implementation would increase costs by 6 to 14 percent of payroll—or 3 to 11 percent of payroll after eliminating the Medicare tax. The study also found that most pension plans for covered employees did not provide supplemental retirement benefits for employees who retire before Social Security benefits are available. For most of the examined pension plans, the present value of lifetime benefits for employees covered by Social Security would be greater than the value of benefits for current noncovered employees.

Our analysis of 1995 Public Pension Coordinating Council data also indicates that retirement costs for states and localities covered by Social Security are higher than the costs for noncovered states and localities. For the pension plans that responded to the survey, the average employee cost rate was about 9 percent of pay in covered plans, including Social Security taxes, and 8 percent of pay in noncovered plans. The average employer cost rate, excluding the cost of unfunded liabilities, was about 12 percent of payroll for employers in covered plans, including Social Security taxes, and 8 percent of payroll for employers in noncovered plans.

These data also indicate that many employees in covered and noncovered plans, especially police and firefighters, retire before age 65, when covered employees would be eligible for full Social Security benefits. Our analysis indicates that covered employees who retire before age 65 initially have a lower salary replacement rate than noncovered employees. The average salary replacement rate with 30 years of service was 53 percent for members of Social Security covered plans and 64.7 percent for members of noncovered plans.

At age 65, however, Social Security covered employees have a higher total benefit than noncovered employees. According to the Department of Labor's 1994 survey, for example, an employee age 65 with 30 years of service, final earnings of $35,000, and Social Security coverage had 87 percent of earnings replaced—51 percent by a pension plan and 36 percent by Social Security. The same employee with no Social Security coverage had 63 percent of earnings replaced by a pension plan. We did not compare the expected value of total lifetime benefits for covered and noncovered employees because amounts would vary depending on the benefits offered by each plan.

Additionally, the extent to which the experience of states and localities with covered employees can be generalized to those with noncovered employees is limited. According to the 1980 study, most public pension plans that coordinated with Social Security did so in the 1950s and 1960s when Social Security benefits and payroll taxes were much smaller. As Social Security benefits grew, pension plan benefits remained basically unchanged. Starting in the 1970s, however, rising pension costs caused several large state systems to consider reducing their relatively liberal pension benefits. In the 1980s, for example, California created an alternative set of reduced benefits for general employees to, among other things, reduce the state's retirement costs. Initially, general employees were permitted to select between the higher costs and benefits of the

original plan and the lower costs and benefits of the revised plan. Subsequently, however, newly hired general employees were limited to the reduced benefits.

Level Retirement Spending Could Mean Reduced Benefits

Several employee, employer, and plan representatives stated that spending increases necessary to maintain level retirement income and other benefits for current and future members would be difficult to achieve. They indicate that states and localities might decide to maintain current spending levels, which could result in reduced benefits under state and local pension plans for many employees.

A June 1997 actuarial evaluation of an Ohio pension plan examined the impact on benefits of mandating Social Security coverage for all employees, assuming no increase in total retirement costs. The study concluded that level spending could be maintained if (1) salary replacement rates for employees retiring with 30 years of service were reduced from 60.3 percent to 44.1 percent, (2) current retiree health benefits were eliminated for both current and future employees, and (3) the funding period for the plan's unfunded accrued liability were extended from 27 years to 40 years.

Impact on Pension Plan Finances Is Uncertain

Most states and localities use a reserve funding approach to finance their pension plans. In reserve funding, employers—and frequently employees—make systematic contributions toward funding the benefits earned by active employees. These contributions, together with investment income, are intended to accumulate sufficient assets to cover promised benefits by the time employees retire.

However, many public pension plans have unfunded liabilities. The nine plans that we examined, for example, have unfunded accrued liabilities ranging from less than 1 percent to over 30 percent of total liabilities. Unfunded liabilities occur for a number of reasons. For example, public plans generally use actuarial methods and assumptions to calculate required contribution rates. Unfunded liabilities can occur if a plan's actuarial assumptions do not accurately predict reality. Additionally, retroactive increases in plan benefits can create unfunded liabilities. Unlike private pension plans, the unfunded liabilities of public pension plans are not regulated by the federal government. States or localities determine how and when unfunded liabilities will be financed.

Mandatory coverage and the resulting changes to plan benefits for newly hired employees are likely to result in reduced contributions to the current pension plan. The impact of reduced contributions on plan finances would depend on the actuarial method and assumptions used by each plan, the adequacy of current plan funding, and other factors. For example, plan representatives are concerned that efforts to provide adequate retirement income benefits for newly hired employees would affect employers' willingness or ability to continue amortizing their current plans' unfunded accrued liabilities.

Legal and Other Considerations

Mandatory coverage presents several legal and administrative issues, and states and localities could require several years to design, legislate, and implement changes to current pension plans.

Legal Considerations

Mandating Social Security coverage for state and local employees could elicit a constitutional challenge. We believe that mandatory coverage is likely to be upheld under current Supreme Court decisions.

Several employer, employee, and plan representatives with whom we spoke stated that they believe mandatory Social Security coverage would be unconstitutional and should be challenged in court. However, recent Supreme Court cases have affirmed the authority of the federal government to enact taxes that affect the states and to impose federal requirements governing the states' relations with their employees.

A plan representative suggested that the Court might now come to a different conclusion. He pointed out that a case upholding federal authority to apply minimum wage and overtime requirements to the states was a 5 to 4 decision and that until then, the Court had clearly said that applying such requirements to the states was unconstitutional. States and localities also point to several recent decisions of the Court that they see as sympathetic to the concept of state sovereignty. However, the facts of these cases are generally distinguishable from the situation that would be presented by mandatory Social Security coverage.

Unless the Court were to reverse itself, which it seldom does, mandatory Social Security coverage of state and local employees is likely to be upheld. Current decisions indicate that mandating such coverage is within the authority of the federal government.

States Would Require Up to 4 Years to Implement Mandatory Coverage

The federal government required approximately 3 years to enact legislation to implement a new federal employee pension plan after Social Security coverage was mandated for federal employees in 1983. According to the 1980 Universal Social Security Coverage Study Group, transition problems for state and local employers would be different from those faced by the federal government. For example, benefit provisions vary among the thousands of public employee retirement plans, as do the characteristics of the employees covered by those plans. Additionally, state governments and many local governments have laws regulating pensions. The study group estimated that 4 years would be required to redesign pension formulas, legislate changes, adjust budgets, and disseminate information to employers and employees. Our discussions with employer, employee, and pension plan representatives also indicate that up to 4 years would be needed to implement a mandatory coverage decision.

Additionally, constitutional provisions or statutes in some states may prevent employers from reducing benefits for employees once they are hired. These states may need to immediately enact legislation to draw a line between current and future employees until decisions are made concerning the pension benefits for new employees who would be covered by Social Security. According to the National Conference of State Legislators, legislators in seven states, including Texas and Nevada, meet only biennially. Therefore, the initial legislation could require 2 years in those states.

Concluding Observations

In deciding whether to extend mandatory Social Security coverage to all newly hired state and local employees, the Congress will need to weigh several factors. First, the Social Security program would benefit from mandatory coverage. The long-term actuarial deficit would be reduced, and the trust funds' solvency would be extended for about 2 years. However, there are other considerations besides this relatively small contribution to the program's solvency. Mandatory coverage would also increase participation in an important national program and simplify program administration.

The implications for state and local employers, employees, and pension plans would be determined in part by employers' responses to Social Security coverage. States and localities with noncovered workers would likely need to increase total retirement spending to provide future workers with pension benefits that, when combined with Social Security benefits,

approximate the benefits provided to current workers. At the same time, Social Security would provide newly hired employees with benefits that are not available, or are available to a lesser extent, under current state and local pension plans.

In addition, mandatory coverage would present legal and administrative issues. States and localities might attempt to halt mandatory Social Security coverage in court, although such a challenge is unlikely to be upheld. Finally, states and localities could require up to 4 years to implement mandatory coverage.

Mr. Chairman, this concludes my prepared statement. At this time, I will be happy to answer any questions you or the other Subcommittee Members may have.

Noncovered Employees and Their Pension Plans

SSA estimates that about 4 million of the approximately 5 million state and local employees not covered by Social Security are in the seven states with the largest number of noncovered workers. (See table I.1.)

Table I.1: States With the Largest Number of Noncovered Workers

State	Number of noncovered employees (in thousands)
California	1,200
Colorado	200
Illinois	400
Louisiana	300
Massachusetts	400
Ohio	800
Texas	700
Total	**4,000**

Source: Office of the Chief Actuary, SSA.

The nine public pension plans included in our study have about 2 million members. For the most part, members of these plans are not covered by Social Security. (See table I.2.)

Table I.2: Membership, Contribution Rates, and Assets for Nine Public Pension Plans

Public pension plan	Active members	Benefit recipients	Contribution rate[a]			Net assets (in billions)
			Employer	Employee	Total	
California State Teachers' Retirement System	364,000	154,000	12.5%	8.0%	20.5%	$74.8
Public Employees' Retirement Association of Colorado	148,000	46,000	11.6	8.0	19.6	19.9
Teachers' Retirement System of Illinois	137,000	59,000	7.9	8.0	15.9	17.4
Louisiana State Employees' Retirement System	70,000	27,000	12.0	7.5	19.5	4.3
Massachusetts State Employees' Retirement System	83,000	42,000	14.5	9.0	23.5	9.6
Massachusetts State Teachers' Retirement System	69,000	29,000	14.0	9.0	23.0	9.9
State Teachers Retirement System of Ohio	169,000	89,000	14.0	9.3	23.3	42.4
Public Employees Retirement System of Ohio	345,000	146,000	13.3	8.5	21.8	39.8
Teacher Retirement System of Texas	695,000	158,000	6.0	6.4	12.4	62.2
Total	**2,080,000**	**750,000**				**$280.3**

[a]Employer rate includes contributions toward the plan's unfunded liability. Employee rate is the rate for general employees.

Source: State and pension plan financial reports.

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