MANDATORY SOCIAL SECURITY COVERAGE OF STATE AND LOCAL WORKERS: A PERENNIAL HOT BUTTON

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INSIDE

Introduction

Some recent proposals to address Social Security's financing shortfall have included an extension of coverage to the 5 million uncovered state and local workers. These proposals spark a predictable outcry from Massachusetts public employees and those in other affected states. This *Issue in Brief* analyzes the arguments for and against mandating Social Security coverage for newly hired state and local workers.[1] The case against mandatory coverage centers on the issue of higher costs for state and local governments. The case for coverage rests on issues of equity and better protection for state and local workers. That is, mandatory coverage would better distribute the burden of paying for the system's legacy debt and would improve benefits; it also would raise costs by about 6 percent of payrolls.

Background

The Social Security Act of 1935 excluded state and local workers from mandatory coverage due to constitutional concerns about whether the federal government could impose taxes on state governments. As Congress expanded coverage to new groups of private sector workers, it also passed legislation in the 1950s that allowed states to elect voluntary coverage for their employees.

The question of mandatory — as opposed to voluntary — coverage for government workers surfaced in the 1960s and 1970s. In response to increasing interest in such a change, the 1977 Amendments to the Social Security Act required a study of the desirability and feasibility of covering all public employees.[2] In the wake of that study, Congress extended mandatory coverage to new federal employees in 1983 and to state and local workers who had no other pension plan in 1990.[3]

Since then, many groups have proposed extending Social Security coverage to all state and local workers

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on the grounds that it is equitable, improves the system's finances, and also improves the insurance benefits of state and local workers. But uncovered state and local governments, unions, and many of their workers, strongly oppose being forced to participate in Social Security. They say that it will impose a big financial burden on states and localities and that public employees will get little in return.[4]

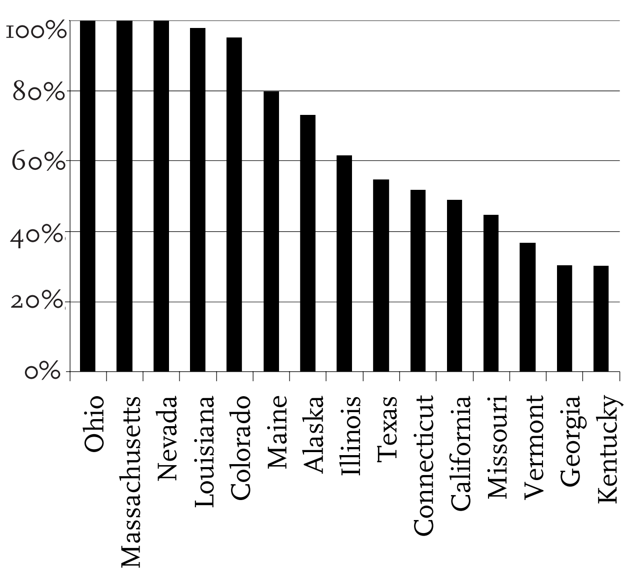
About 30 percent of the state and local workforce — roughly 5 million workers — still are not covered by Social Security. The bulk of uncovered workers (75 percent) reside in seven states — California, Colorado, Illinois, Louisiana, Massachusetts, Ohio, and Texas.[5] In California, Illinois, and Texas, uncovered state and local workers constitute 49 percent, 62 percent, and 55 percent of the total, respectively (Figure 1). In Colorado, Louisiana, Massachusetts, and Ohio, virtually no government workers are covered by Social Security.

The Case for Mandatory Coverage

Although enthusiasm for covering all state and local workers is often linked with reducing Social Security's long-run deficit, the most compelling arguments rest on issues of equity and ensuring that all state and local workers have protections not currently provided under public plans.

Figure 1. Uncovered Workers are Concentrated in a Few States

Percent of State and Local Government Employees Not Covered by Social Security, 1996



Source: Munnell (2000), Table 11.

Equity Considerations

Excluded state and local government employees, and their employers — ultimately the taxpayers in those states — are not paying their share of financing the legacy costs associated with the startup of the Social Security program. Nor are they paying their share of the income redistribution in the Social Security program.

The most important equity issue relates to the legacy costs. When Social Security started, the President and Congress decided to pay benefits to the first generation of retirees whose lives had been disrupted by the Great Depression. The workers who had paid taxes only for a short period received benefits far in excess of their contributions. These net transfers continued for many years, and totaled roughly $10 trillion. Roughly 3 percentage points of the current 12.4 percent payroll tax go towards covering the startup costs.[6] In other words, 25 percent of the Social Security tax goes to cover the implicit interest costs of the early transfers. The early benefits during the 1940s, 1950s and 1960s went to the parents, grandparents, and great grandparents of today's uncovered state and local workers. Those who support mandatory coverage believe that state and local workers — and the taxpayers in those states — should pay their share of the inherited legacy costs.

The second equity issue is straightforward. Social Security redistributes income from workers with higher lifetime earnings towards workers with lower lifetime earnings. To the extent that higher paid people do not participate — and state and local workers are generally higher paid — they place an extra burden on the rest of the population. The excluded state and local workers and the taxpayers of those states benefit from this redistribution in that they have to pay fewer taxes for means-tested programs for the elderly, and they live in a society with fewer poor elderly than would exist in the absence of Social Security. Advocates of universal coverage contend that it is only fair that state and local government workers and their employers, like their private and public sector counterparts, participate in this national endeavor.

Improved Protection for State and Local Workers and Their Families

Equity considerations are only half the story, however. Social Security coverage also would provide important protections for state and local workers and their families that they do not have now. This is because state and local workers face gaps in insurance protection and gaps in benefits.

Legislation Has Curtailed the Gains from 'Double Dipping'

The exclusion of some state and local workers from Social Security used to raise further equity problems. State and local workers who are not covered by Social Security in their government work can easily gain coverage as a result of a second career or moonlighting. Since a worker's monthly earnings for purposes of benefit calculation are averaged over a typical working lifetime rather than over the years actually spent in covered employment, a high-wage earner with a short period of time in covered employment cannot be distinguished from an individual who worked a lifetime in covered employment at an exceptionally low wage. Thus, a worker who was entitled to a state and local pension and to Social Security could qualify for the subsidized benefits associated with the progressive benefit formula. Similarly, a spouse who had a full career in uncovered employment — and worked in covered employment for only a short time or not at all — would be eligible for the spouse's and survivor's benefits.

In 1977, Congress established the Government Pension Offset (GPO) and in 1983 introduced the Windfall Elimination Provision (WEP) to reduce the unfair advantage enjoyed by these double dippers and/or their spouses. The WEP instituted a modified benefit formula for people who qualify for a Social Security benefit based on a brief work history and who have earned a pension in noncovered employment. The GPO reduces spouses' benefits for those who have a government pension in noncovered employment. Although these provisions may not produce perfect adjustments for each individual, in the aggregate they have substantially solved the problem.[7]

Gaps in Insurance Protection

The most serious gap in insurance protection relates to disability insurance. Workers moving between jobs that are covered by Social Security and jobs that are not covered may experience long periods without disability protection. When young workers leave covered employment and go to work for a state or local government not covered by Social Security, their insured status for disability benefits under Social Security may lapse. (This lapse occurs because workers must have worked 5 of the last 10 years in covered employment to qualify for disability benefits.) Since it may take five or even 10 years to become insured for disability under the public plan, they will have a significant period with no protection at all. Similarly, a worker who leaves a noncovered state or local plan may have to wait five years before gaining disability insurance under Social Security. Although many of these workers are young, should a disability occur, they would face a very long period with little earnings.

Gaps in Benefit Protection

Gaps in benefit protection arise because state and local plans do not provide the portability, dependents' and survivors' benefits, and full cost-of-living adjustments offered by Social Security.

Workers covered by state and local defined benefit plans lose benefits when they move from one job to another, since portability of state and local defined benefit pensions is usually limited to employment within state government. Defined benefit plans have the advantage of offering a predictable benefit, expressed as a percent of final pay for each year of service. But because benefits are based on *final* pay, mobile employees receive significantly lower benefits as a result of changing jobs than they would have received from continuous coverage under a single plan. That is, the worker who remains with a plan receives benefits related to earnings just before retirement, but the benefits for mobile employees are based on earnings at the time they terminate employment. In contrast, Social Security allows employees to build on previous earnings as they move from job to job, so mobility does not reduce benefits.

Second, most state and local plans provide little in the way of dependents' benefits. They provide nothing for a spouse of a retired worker when the worker is alive; Social Security offers a benefit equal to 50 percent of the employee's for spouses without significant earnings records and provides benefits to divorced spouses who have been married at least 10 years. State and local plans generally offer only modest survivor benefits: before retirement the benefit is often either a refund of employees' contributions or a lump sum, whichever is greater. After retirement, survivor benefits are available only if the employee selects a joint-and-survivor option for his annuity. The extent to which workers select such an option is problematic. In contrast, Social Security provides widow's benefits equal to 100 percent of the worker's pension and also provides benefits to young widows.

Third, state and local pension plans generally provide some post-retirement cost-of-living adjustments, and those plans where workers do not have Social Security coverage tend to provide more protection. Nevertheless, the cost-of-living adjustments are generally capped at 3 percent, and it is unclear what the sponsors of these plans would do if inflation were substantially higher. Social Security, on the other hand, provides full cost-of-living adjustments no matter how rapid inflation might be, ensuring that beneficiaries do not see the value of their pension benefits eroded.

Social Security's guarantee of portability, full inflation protection, and generous ancillary benefits means that extending mandatory coverage would bring real gains to state and local workers and their spouses. Coverage under a national social insurance system would also eliminate gaps in disability protection that occur as workers move between covered and noncovered employment.

The Costs of Mandatory Coverage

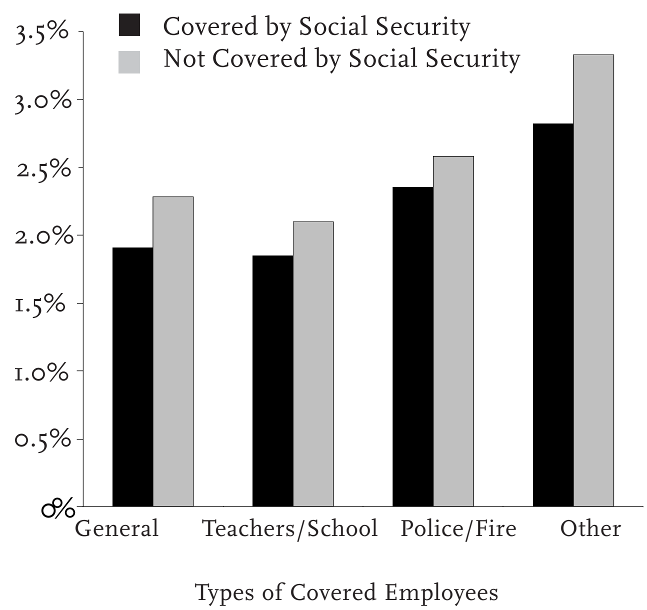
The arguments against mandatory coverage center on the issue of costs. Opponents of mandating Social Security coverage for state and local workers also raise concerns about destabilizing existing plans for current employees and about morale issues associated with having new employees receive different pension benefits than current workers. Others raise the issue of administrative burden.

Almost all proposals for mandating Social Security coverage are limited to new employees only.[8] Although covering only new employees eases the transition, once the transition is complete state and local governments would face the full impact of the cost. The ultimate cost of the combined Social Security/public pension system depends crucially on how plan sponsors respond to the introduction of Social Security. States and localities are unlikely to simply add Social Security on top of existing provisions; the resulting package would be too expensive and produce unduly high benefits. Indeed, benefit accrual rates are lower for plans covered by Social Security than for those plans not covered (see Figure 2).

Studies conducted in the 1980s and 1990s estimated the average cost increase assuming that state and local governments reduced their own plan benefits to the point where the new Social Security/public program preserved the average worker's first year benefits.[9] Typically, these studies showed a total increase in costs of about 5 to 6 percent of new employee payrolls. Some states — Colorado, Illinois, and Ohio — have also estimated the cost of mandatory Social Security coverage and come up with slightly higher estimates — from 6 to 7 percent of new employee payrolls.[10]

Figure 2. Pension Accruals are Higher for Workers not Covered by Social Security

Average Annual Benefit Percentage per Year of Service for State and Local Plans by Type of Covered Employee, 2000



Source: Harris (2002), Table I-3

These studies typically duplicated first-year benefits for an unmarried worker in the middle of the age, service, and pay scales. This means that state and local workers in these projections would actually get more in lifetime benefits under the combined Social Security/public system. This is because Social Security provides full cost-of-living adjustments and generous spouse and survivor retirement benefits. If the goal were to equalize lifetime benefits, public plans could be cut back more than assumed in most calculations.

Even with an equivalently valued benefit package, costs for state and local plans would increase with mandatory Social Security coverage. This increase is due to the burden associated with the legacy costs and redistribution to lower paid workers.

Who would pay these costs? Most likely the cost for the improved benefits would be borne by the workers. If state and local governments were to pay 3 percent of payrolls to improve the typical employee's benefits, the only way to keep the total compensation package the same would be to reduce another component such as other fringe benefits or cash wages.[11] On the other hand, the government employer will not remain competitive in the labor market if it tries to further reduce compensation to cover the other 3 percent of payroll cost associated with redistribution and the legacy costs. Wages would need to rise by an amount sufficient to cover that cost. So it would likely be borne by taxpayers. Thus, in the states with formerly uncovered workers, expanding coverage will shift the burden from lower paid workers who contribute through the payroll tax to higher income residents who contribute through income taxes.

Extending coverage to all workers raises costs, but improves benefits and equity.

In addition to concern about higher costs, some opponents suggest that mandatory coverage could destabilize existing systems and create morale problems when state and local workers with different levels of seniority have different pension plans. The morale issue does not appear to have been a problem at the federal level when the federal government introduced a new pension system in 1986. Redesigning the plan does require opening up pensions for negotiation in the case of unionized workers, which raises the possibility of ending up with a very different type of pension arrangement. A dramatic change in pension design seems unlikely, however, since the vast majority of state and local systems with Social Security coverage remain defined benefit. Police and firefighters should have the least to fear, since localities would have to retain most of their existing pension provisions to accommodate the early retirement needs of these workers in physically demanding jobs. Of course, benefits for these workers may be structured to decline once they become eligible for Social Security benefits at age 62 or the normal retirement age.

Some argue that extending Social Security coverage to the 30 percent of state/local workers currently not covered would be a serious administrative burden. It is important to remember, however, that all employees and employers in the private sector and 70 percent in the public sector now participate in Social Security. The states would require some time to adapt their plans to mandatory coverage provisions. The federal government required three years to enact a new federal pension plan after Congress mandated Social Security coverage for federal employees in 1983. A study by the General Accounting Office reports that their discussions with employers, employees, and pension officials suggest that four years would be required to complete the complex task of negotiating with state legislatures and employee representatives.[12] Once negotiated, however, the administrative requirements should not be significant. After all, states and localities already withhold money from workers for federal personal income tax purposes; the additional administrative costs associated with payroll tax deductions should be minimal.

In short, the major argument against mandating coverage of all state and local workers under Social Security is not administrative burden, morale, or destabilizing public plans, but rather its cost.

The Impact of Mandatory Coverage on Social Security Finances

Every year, the Social Security Trustees publish an actuarial report that includes three sets of projections based on alternative economic and demographic assumptions. The intermediate projection from the 2005 Report shows that over the next 75 years, Social Security has a long-run deficit equal to 1.92 percent of covered payroll earnings. The Social Security actuaries estimate that extending coverage to all new state and local workers would reduce the 75-year deficit by about 10 percent (0.22 percent of taxable payrolls) and would extend the trust fund solvency by about 2 years.[13]

Mandating coverage for all state and local workers would help reduce Social Security's financing shortfall for three reasons. First, 3 percentage points of the increased contributions of the newly covered workers would go towards covering the program's legacy costs. Second, state and local workers tend to be higher wage workers and therefore receive relatively low benefits due to Social Security's progressive benefit formula. Finally, extending coverage affects cost because the Social Security projections run for only 75 years. Thus, workers who pay taxes within the 75-year horizon but receive at least part of their benefits after the horizon help the actuarial calculation, even if they do not help from a lifetime perspective.

Conclusion

The arguments for mandatory Social Security coverage rest on equity. While mandatory Social Security coverage may be equitable and improve benefits, it will raise costs by 5 to 6 percent of payroll. Part of the increase reflects improved real benefits, the cost of which will probably be borne by the workers; part reflects a tax to cover Social Security's legacy costs, the burden of which will probably be borne by the taxpayer.

Endnotes

1 Much of this *brief* is based on an extensive study of the coverage of state of local workers for AARP; see Munnell, 2000.

2 This effort culminated in U.S. House of Representatives, Committee on Education and Labor (1978).

3 The constitutional issues involved have not been fully resolved. The decision to extend mandatory coverage of Medicare to state and local workers has not been challenged, and, in a unanimous decision, the Court upheld a provision in the 1983 Social Security Amendments that prevented states from withdrawing from Social Security. On the other hand, in more recent decisions the United States Supreme Court has shifted more toward upholding states rights. Thus, how the Court would rule regarding mandatory Social Security coverage seems less certain today than it did even a few years ago. If the court ruled against direct taxation of state and local governments, the federal government could always tie some federal aid to coverage of all state and local workers. Thus, the real issues are costs versus equity — not the mechanics.

4 White House Conference on Social Security (1998); Segal Company (1999); and AFL-CIO Public Employee Department (1979).

5 Social Security Administration Office of the Inspector General (1996) and Segal Company, (1999).

6 Geanakoplos, Mitchell, and Zeldes (1998).

7 A brief survey of the literature produced no articles characterizing the offsets as inadequate. In fact, the only reports were that several members of Congress have introduced legislation to mitigate their effect. On a purely administrative level, however, the General Accounting Office (GAO) (1998a) reported that the Social Security Administration cannot always determine whether an applicant should be subject to WEP or GPO, and this failure has led to some overpayments. GAO estimated total overpayments for the period 1978 to 1995 were between $160 million and $335 million. These amounts are relatively small, however, and play only a minor role in the arguments for mandatory Social Security coverage for state and local workers. Kollman (1990) also concludes that the provisions have ameliorated the problem in the aggregate, even though high income people may be somewhat penalized and low income individuals may enjoy less than a full offset.

8 1994-96 Advisory Council on Social Security, (1997); Moynihan, (1999); and most recently Diamond and Orszag (2004). Focusing on new employees avoids personnel problems and legal challenges associated with benefit reductions for existing personnel; it requires no hold harmless provisions; it means each employee deals with only one benefit formula; and it allows a gradual phase-in of the required tax increase.

9 Actuarial Education and Research Fund (1979) and U.S. House of Representatives, Committee on Ways and Means and Commiittee on Post Office and Civil Service (1980).

10 Colorado State University (1998); Denver Public School Employees' Pension and Benefit Association (1999); Fire and Police Pension Association of Colorado (1999); Public Employees' Retirement Association of Colorado (1999a). Public Employees' Retirement Association of Colorado (1999b); Public Employee Retirement System of Ohio (1997). "

11 For a discussion of wage setting in the public sector, see Ehrenberg, (1980) and Smith and Ehrenberg (1983).

12 U.S. General Accounting Office (1998b).

13 Advisory Council on Social Security (1997). A 2004 estimate from the Social Security actuaries on the financial impact of extending coverage to state and local workers is roughly consistent with the estimate in the 1997 report.

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