United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Social Security, Committee on Ways and Means, House of Representatives

August 1998

SOCIAL SECURITY

Implications of Extending Mandatory Coverage to State and Local Employees

GAO

United States
General Accounting Office
Washington, D.C. 20548

Health, Education, and Human Services Division

B-278999

August 18, 1998

The Honorable Jim Bunning
Chairman, Subcommittee on Social Security
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

The Social Security Act of 1935 excluded state and local government employees from coverage because there was concern over the question of the federal government's right to impose a tax on state governments and because many state and local employees were already protected by public pension plans. Since 1935, the Congress has extended mandatory Social Security coverage to state and local employees not covered by a public pension plan and voluntary coverage to other state and local government employees.[1] The Social Security Administration (SSA) estimates that about 5 million state and local government employees, with annual salaries totaling about $132.5 million, are currently occupying positions not covered by Social Security.

Under current estimates, Social Security revenues will fall short of expenditures and the Trust Funds will be exhausted by 2032. The 1994-1996 Social Security Advisory Council[2] could not agree on how to resolve Social Security's financial shortfall, but groups of council members coalesced around three proposals. A common element of the three proposals was to extend mandatory coverage to all newly hired state and local government workers.

You asked us to examine the implications of extending mandatory coverage to all newly hired state and local employees. Specifically, you asked us to examine the implications of mandatory coverage for the Social Security program and for public employers, employees, and pension plans. You also asked us to identify potential legal or administrative problems associated with implementing mandatory coverage. We presented

[1]Coverage is generally at the option of the state, and employees who are members of a retirement system have a choice as a group with respect to coverage.

[2]The Social Security Act, as amended, required the appointment of an advisory council every 4 years to examine issues related to the Social Security and Medicare programs. Under provisions of the Social Security Independence and Program Improvements Act of 1994 (P.L. 103-296), the 1994-1996 Advisory Council was the last advisory council to be appointed.

preliminary findings in testimony before this Subcommittee on May 21, 1998.[3]

In response to your request, we examined SSA's estimates of the impact of mandatory coverage for Social Security revenues, expenditures, and trust fund balances. We discussed the implications of mandatory coverage with state and local government employer, employee, and pension plan representatives in the seven states that account for over 75 percent of the noncovered payroll. We also examined relevant studies provided by these representatives. We reviewed a 1980 study of the feasibility of extending mandatory coverage to state and local employees prepared at the request of the Congress and two 1994 surveys of state and local pension plan costs and benefits. We discussed the financial implications of mandatory coverage for public pension plans with actuaries and representatives of state and local pension plans for covered and noncovered employees. Our methodology is described in more detail in appendix 1.

Results in Brief

SSA estimates that extending mandatory Social Security coverage to all newly hired state and local government employees would reduce the program's long-term actuarial deficit by about 10 percent and would extend the trust funds' solvency by about 2 years. In addition to helping to some extent resolve the solvency problem, mandatory coverage would broaden participation in an important national program and simplify program administration.

The effect on public employers, employees, and pension plans would depend on how state and local governments with noncovered employees respond to the additional costs and benefits associated with Social Security coverage. Social Security retirement benefits are fully protected from inflation and are weighted in favor of families and low-income employees. Many public pension plans, on the other hand, permit employees to retire earlier and provide a higher retirement income benefit than Social Security. Those states and localities that decide to maintain benefit levels for new employees consistent with the earlier retirement age and enhanced retirement income benefit would experience increased costs. However, those employees would also have the additional family and other protection provided by Social Security. Alternatively, states and localities that choose to maintain level retirement spending might need to reduce some retirement benefits for newly hired employees.

[3]Social Security: Mandating Coverage for State and Local Employees (GAO/T-HEHS-98-127, May 21, 1998).

Several employer, employee, and plan representatives stated that mandating Social Security coverage for all new state and local government employees would raise constitutional issues and would be challenged in court. However, we believe that mandatory coverage is likely to be upheld under current U.S. Supreme Court decisions. Mandatory coverage would also present administrative issues for implementing state and local governments. Up to 4 years could be required for states and localities to develop, legislate, and implement pension plans that are coordinated with Social Security.

Background

The Social Security Act of 1935 required most workers in commerce and industry, then about 60 percent of the workforce, to be covered. Amendments to the act in 1950, 1954, and 1956 allowed states, generally acting for their employees, to voluntarily elect Social Security coverage through agreements with SSA. The amendments also permitted states and localities that elected coverage to withdraw from the program after meeting certain conditions.

Policymakers have addressed the issue of extending mandatory Social Security coverage for state and local government employees on several occasions. In response to financial problems the Social Security system faced in the early 1970s, for example, the 1977 Social Security amendments directed that a study be made of the desirability and feasibility of extending mandatory coverage to employees at all levels of government, including state and local governments. The Secretary of the Department of Health, Education, and Welfare—now the Departments of Health and Human Services and Education—established the Universal Social Security Coverage Study Group to develop options for mandatory coverage and analyze the fiscal effects of each option.

Recognizing the diversity of state and local systems, the study group selected representative plans for analysis. Two data sources were developed and analyzed. First, the Actuarial Education and Research Fund, sponsored by six professional actuarial organizations, established a task force of plan actuaries to study 25 representative large and small noncovered retirement systems. Second, the Urban Institute, under a grant from several government agencies, used an actuarial firm to obtain data on 22 of the largest 50 noncovered employee retirement systems. The study group report, issued in 1980, provided information on the costs and benefits of various options but did not draw conclusions about their relative desirability.[4]

In 1983, the Congress removed authority for states and localities that had voluntarily elected Social Security coverage to withdraw from the program, which effectively made coverage mandatory for many state and local employees. Additionally, in 1990, the Congress mandated coverage for state and local employees not covered by public pension plans. SSA estimates that 96 percent of the workforce, including 70 percent of the state and local government workforce, is now covered by Social Security.

During 1997, Social Security had $457.7 billion in revenues and $369.1 billion in expenditures. About 89 percent of Social Security's revenues came from payroll taxes. The Social Security payroll tax is 6.2 percent of pay each for employers and employees, up to an established maximum. Maximum earnings subject to Social Security payroll taxes were $65,400 in 1997 and are $68,400 in 1998.

Social Security provides retirement, disability, and survivor benefits to insured workers and their families. Insured workers are eligible for full retirement benefits at age 65 and reduced benefits at age 62. The retirement age was increased by the 1983 Social Security amendments. 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.

Benefit amounts are based on a worker's age and career earnings, are fully indexed for inflation, and as shown in table 1, replace a relatively higher proportion of the final year's wages for low earners.

Table 1: Estimated Average Social Security Earnings Replacement Rates Based on Intermediate Assumptions in the 1998 Trustees Report

Year of retirement	Retirement age	Low earner[a]	Average earner	Maximum earner[b]
2000	65	55.4	41.2	24.2
2015	66	56.7	42.2	27.7
2040	67	56.5	42.1	27.7

[a]Equal to 45 percent of the average wage.

[b]Equal to maximum earnings subject to Social Security payroll taxes.

Source: Office of the Chief Actuary, SSA.

[4]Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage for Employees of Federal, State, and Local Governments and Private, Nonprofit Organizations (Mar. 1980).

Social Security provides additional benefits for eligible family members, including spouses aged 62 or older—or younger spouses if a child meeting certain requirements is in their care—and children up to age 18—or older if they are disabled. The amount of a spouse's or child's benefit is one-half the insured worker's age-65 benefit amount. A spouse's benefit is reduced if taken earlier than age 65, unless the spouse has a child in his or her care.

SSA estimates that about 5 million state and local government employees, excluding students and election workers, occupy positions not covered by Social Security. SSA also estimates that the noncovered employees have annual salaries totaling about $132.5 billion. Seven states—California, Colorado, Illinois, Louisiana, Massachusetts, Ohio, and Texas—account for over 75 percent of the noncovered payroll. Based on a 1995 survey of public pension plans,[5] the Public Pension Coordinating Council (PPCC) estimates that police, firefighters, and teachers are more likely to occupy noncovered positions than other employees are.

According to a 1994 Bureau of Labor Statistics (BLS) survey,[6] most full-time state and local employees participate in defined benefit pension plans. Table 2 shows membership and contribution rates for nine defined benefit state and local pension plans that we studied as part of the review. For the most part, active members in the nine plans occupy positions that are not covered by Social Security.

[5]Paul Zorn, Survey Report: 1995 Survey of State and Local Government Employee Retirement Systems (Washington, D.C.: PPCC, July 1996).

[6]BLS, Employee Benefits in State and Local Governments, 1994, Bulletin 2477 (Washington, D.C.: Department of Labor, May 1996).

Table 2: Membership, Contribution Rates, and Assets for Selected Public Pension Plans

Public pension plan	Active members	Benefit recipients	Contribution rate[a] Employer	Employee	Total	Net assets (billions)
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 the State 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 Retirement System	83,000	42,000	14.5	9.0	23.5	9.6
Massachusetts Teachers' Contributory 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]The employer rate includes contributions toward the plan's unfunded liability. Several plans have multiple employee contribution rates. The rate provided is for state employees, excluding special-rate groups, such as state police.

Source: State and pension plan financial reports.

Defined benefit plans promise a specific level of benefits to their members when they retire. Minimum retirement age and benefits vary; however, the BLS and PPCC surveys indicate that many public employees can retire with full benefits at age 55 or earlier with 30 years of service. The surveys also indicate that plan members typically have a benefit formula that calculates retirement income on the basis of specified benefit rates for each year of service and the members' average salary over a specified time period—usually the final 3 years.

For example, the benefit rates for members of the Colorado Public Employees' Retirement Association are 2.5 percent of highest average salary per year over a 3-year period for the first 20 years of service and 1.5 percent of highest average salary per year for each additional year of service. Full retirement benefits are available at any age with 35 years of service, at age 55 with 30 years of service, age 60 with 20 years of service, or at age 65 with 5 years of service. Therefore, plan members who retire at age 55 with 30 years of service receive annual retirement income amounting to 65 percent of their highest average salary. Reduced retirement benefits are available, for example, at age 55 with 20 years of service.

In addition to retirement income benefits, most public pension plans provide other benefits, such as disability or survivor benefits. For example, BLS reported that of defined benefit plan members, 91 percent were provided with disability benefits, all have a survivor annuity option, and 62 percent receive some cost-of-living increases after retirement.

Public pension plan coverage for part-time, seasonal, and temporary employees varies. In Ohio, for example, part-time and temporary state employees participate in a defined benefit plan. In California, the 16,000 part-time, seasonal, and temporary state employees have a defined contribution plan. Plan benefits are based on plan contributions, which consist of 7.5 percent of the employees' gross pay deducted from their pay and returns on plan investments.

Mandatory Coverage Would Benefit the Social Security Program

SSA estimates that extending mandatory Social Security coverage to all newly hired state and local employees would reduce the trust funds' 75-year actuarial deficit by about 10 percent.[7] The surplus payroll tax revenues associated with mandatory coverage and interest on that surplus would extend the trust funds' solvency by about 2 years. Extending mandatory coverage to newly hired employees would also increase program participation and, in the long run, simplify program administration.

Trust Funds' Deficit Would Be Reduced

Table 3 shows SSA's analysis of the present discounted value of revenues and expenditures with and without mandatory coverage over the 75-year period beginning January 1, 1998. The analysis indicates that extending mandatory coverage to all state and local employees hired beginning January 1, 2000, would reduce the program's long-term actuarial deficit by 10 percent, from about 2.19 percent of payroll to 1.97 percent of payroll.

[7]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.

Table 3: Present Value of Social Security Revenues and Expenditures and Actuarial Balance Over 75 Years With and Without Mandatory Coverage

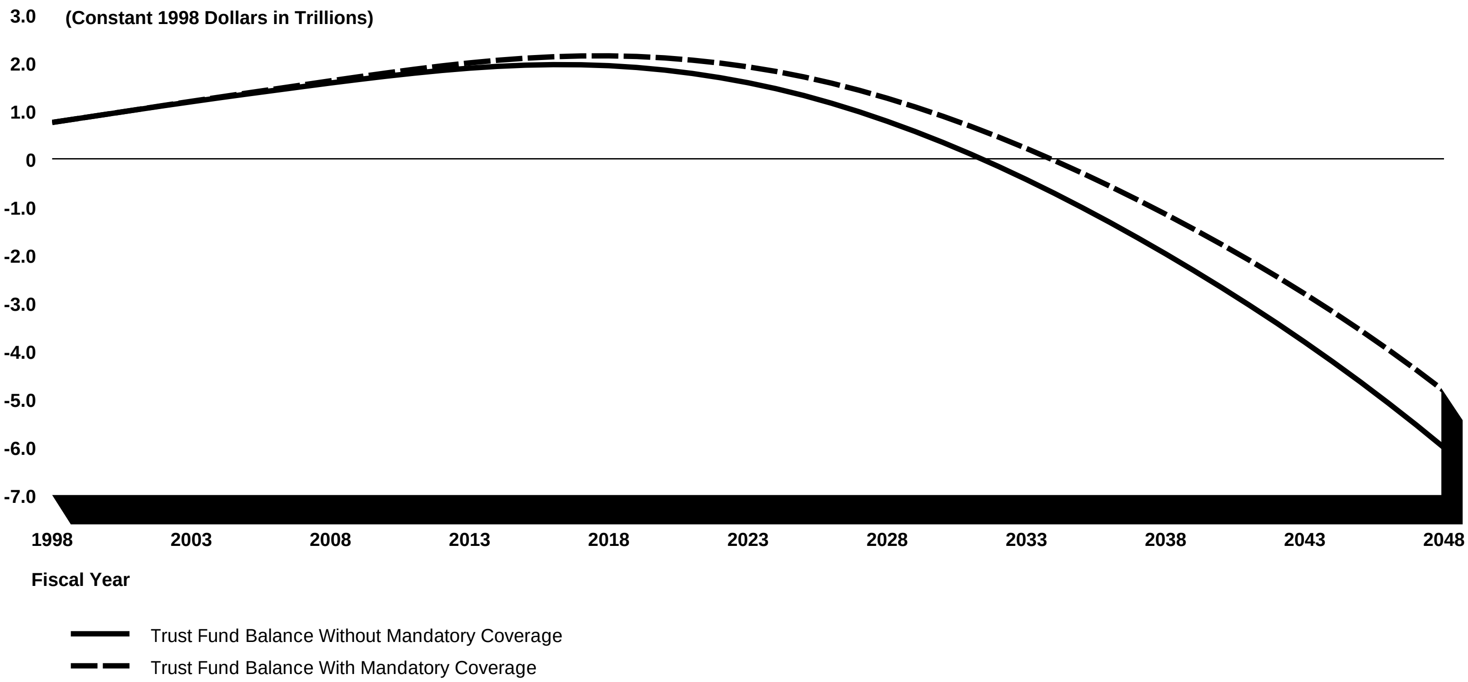
	Without mandatory coverage (billions)	With mandatory coverage (billions)	Change (billions)
Beginning trust fund balance	$655.5	$655.5	$0.0
Present value of total revenues	18,413.4	18,934.6	521.2
Present value of total expenditures	21,983.0	22,274.7	291.7
Revenue minus expenditures	(3,569.6)	(3,340.1)	229.5
Target trust fund balance[a]	185.4	192.7	7.3
Actuarial balance	(3,099.5)	(2,877.3)	222.2
Present value of payroll	141,779.0	145,878.9	4,099.9
Actuarial balance as a percent of payroll	(2.19)	(1.97)	0.22

[a]The target trust fund balance is an amount equal to the following year's projected expenditures.

Source: SSA, Office of the Chief Actuary.

Figure 1 shows that SSA's analysis indicates that extending mandatory coverage to new state and local employees would extend the trust funds' 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, extending mandatory coverage to newly hired state and local employees would contribute to the resolution of—but not fully resolve—the trust funds' solvency problem. A combination of adjustments will be needed to extend the program's solvency over the entire 75-year period.

Figure 1: Comparison of Projected End-Of-Year Trust Fund Balances With and Without Mandatory Coverage, From 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's analysis indicates that revenues resulting from an extension of mandatory coverage, including payroll taxes and interest on surplus revenues, 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 accelerate until later in the period. For example, annual revenues from payroll taxes collected from the newly covered employees and their employers are expected to exceed expenditures for benefits to those employees until 2050. In that year, however, revenues resulting from an extension of mandatory coverage, including interest on cumulative surplus revenues, are projected to exceed expenditures on those employees by over 300 percent.

Mandatory Coverage Would Have Other Beneficial Effects

While Social Security's solvency problems triggered the analysis of the effect of mandatory coverage on program revenues and expenditures, the inclusion of such coverage in a comprehensive reform package would likely be grounded in other considerations as well, such as broadening Social Security's coverage and simplifying program administration.

According to SSA, about 91 percent of elderly households received Social Security benefits in 1994.[8] Social Security contributes substantially to reducing poverty in these households. For example, in 1994, 11.7 percent of persons age 65 or over were poor. Excluding Social Security benefits, however, the incomes of about 54 percent of persons age 65 or older would have been below the poverty threshold.[9] In recommending that mandatory coverage be included in its 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.

According to SSA, one important way that noncovered employees benefit from, without contributing to, Social Security is that their parents, grandparents, or other relatives receive Social Security's retirement, disability, or survivor benefits. Social Security is designed as a national intergenerational transfer program where the taxes of current workers fund the benefits of current beneficiaries. SSA stated that those not contributing to the program still receive the benefits of this transfer.

Extending mandatory Social Security coverage to all newly hired state and local employees would also simplify program administration by eliminating, over time, the need to administer and enforce special rules for noncovered state and local employees. For example, SSA's Office of Research, Evaluation, and Statistics estimates that 95 percent of state and local employees occupying noncovered positions become entitled to Social Security as either workers or dependents. Additionally, the Office of the Chief Actuary estimates that 50 to 60 percent of state and local employees in noncovered positions will be fully insured by age 62 from other, covered employment.

[8]Susan Grad, Income of the Population 55 or Older, 1994 (Washington, D.C.: SSA, Office of Research and Statistics, 1996).

[9]However, without Social Security, people may save more or continue working.

The Congress established the Windfall Elimination Provision (WEP) and Government Pension Offset (GPO) to reduce the unfair advantage that workers eligible for pension benefits on the basis of noncovered employment may have when they apply for Social Security benefits. The earnings history for workers with noncovered earnings may appear to qualify them for increased Social Security benefits as low-income wage earners—or for additional benefits for a nonworking spouse—when in fact they have had substantial income from noncovered employment. With a few exceptions, WEP and GPO require SSA to use revised formulas to calculate benefits for workers with noncovered employment.

In April 1998, we reported that SSA is often unable to determine whether applicants should be subject to WEP or GPO and this has led to overpayments.[10] We estimated total overpayments to be between $160 million and $355 million over the period 1978 to 1995. In response, SSA plans to perform additional computer matches with the Office of Personnel Management and the Internal Revenue Service (IRS) to obtain noncovered pension data and ensure WEP and GPO are correctly applied. Mandatory coverage would reduce required WEP and GPO adjustments to benefits by gradually reducing the number of employees in noncovered employment. 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, and adjustments would be unnecessary.

In 1995, SSA asked its Office of the Inspector General to review state and local government employers' compliance with Social Security coverage provisions. In December 1996, the Inspector General reported that Social Security provisions related to coverage of state and local employees are complex and difficult to administer.[11] 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 have initiated an effort to educate employers and ensure compliance with legal requirements for withholding Social Security payroll taxes. Extending coverage to all newly hired state and local government employees would eventually eliminate this problem.

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

[11] SSA Office of the Inspector General, Social Security Coverage of State and Local Government Employees (A-04-95-06013, Dec. 13, 1996).

SSA stated that the time needed to fully phase in mandatory coverage could be 20 to 30 years, if it followed estimates of the time needed to phase in Medicare coverage, which was mandated for newly hired state and local employees starting in 1986. SSA also stated that mandatory Social Security coverage for new hires would possibly create another tier in the payroll reporting process resulting in additional compliance issues in the near term. Additionally, payroll practitioners would need to account for Social Security covered and noncovered government employment—along with Medicare covered and noncovered employment—and, as a result, they would face additional reporting burdens in the near term as they extended Social Security coverage to new employees.

Effect of Mandatory Coverage for Employers, Employees, and Their Public Pension Plans Would Vary

If Social Security becomes mandatory, all newly hired state and local employees would be provided with the minimum income protection afforded by Social Security. Also, they and their employers would pay Social Security's combined 12.4-percent payroll tax. Each state and locality with noncovered employees would then decide how to respond to the increase in benefits and costs. Possible responses range from the government's absorbing the added costs and leaving current pension plans unchanged to entirely eliminating state and local pension plan benefits for newly hired employees.

From discussions with state and local representatives, however, noncovered employers would likely adjust their pension plans to reflect Social Security's benefits and costs. To illustrate the implications of mandatory coverage for public employers and employees, we examined three possible responses:

- States and localities could maintain similar total retirement benefits for current and newly hired employees. For example, employees who retire before age 62 would be paid supplemental retirement benefits until they become eligible for Social Security benefits. This response would likely result in an increase in total retirement costs and some additional family and other 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. For example, employees who retire before age 62 would receive, on average, a smaller initial retirement benefit than current noncovered employees. This response would also likely result in an increase in total retirement costs and some additional family and other benefits for newly hired employees.

- States and localities could maintain level retirement costs. This response would likely require a reduction in pension benefits from the government's plans for many newly hired employees, but the new employees would also have Social Security benefits.

According to pension plan representatives, the changes to current pension plans in response to mandatory coverage could result in reduced contributions to those plans, which could affect their long-term financing.

Maintaining Benefits of Noncovered Employees for Newly Hired Employees Would Likely Increase Costs

States and localities with noncovered employees could decide to provide newly hired employees with pension benefits at retirement, which, when combined with Social Security benefits, approximate the pension benefits of current employees. Studies indicate that such a decision would likely result in an increase in retirement costs. The amount of increase would vary depending on a number of factors; however, studies indicate the increase could be about 7 percent of new-employee payroll.

The 1980 Universal Social Security Coverage Study Group report estimated that total retirement costs, including Social Security payroll taxes and pension plan contributions, would need to increase an average of 5 to 10 percent of payroll to maintain level benefits for current and newly hired employees. However, the estimated increase included the 2.9 percent of payroll Medicare tax that was mandated for all new state and local employees in 1986—6 years after the study was completed. Deducting the Medicare tax reduces the estimate of additional costs to between 2 and 7 percent of payroll.

The 1980 study group assumed that most newly hired employees would have salary replacement percentages in their first year of retirement that would be comparable to the salary replacement percentages 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 weighted in favor of families and lower income employees—and because Social Security benefits are fully indexed for inflation, while many pension plans provide limited or no cost-of-living protection—total lifetime benefits for some new employees would be greater than those provided to current employees.

More recent studies by pension plan actuaries in Colorado, Illinois, and Ohio also indicate the cost increase would be in the same range. For example, a December 1997 study for a plan in Ohio indicated that providing retirement benefits for new employees that, when added to Social Security benefits, approximate retirement 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 retirement benefits for current and new employees would be about 6.5 percent of new-employee payroll. Since it would be limited to new employees, the cost increase would be phased in over several years. For example, the cost increase would be about 0.25 percent of total payroll starting the first year, 2.83 percent of total payroll in 10 years, and 6.54 percent of total payroll after all current employees have been replaced.

The 1980 study group report stated that the causes of the cost increase cannot be ascribed directly to specific Social Security or pension plan provisions. According to the study, however, among the most important factors contributing to the cost increase are Social Security's

- strengthening of cost-of-living protection,
- provision of substantial additional benefits to some families, and
- reduction in pension benefit forfeitures occurring when employees move between jobs.

The study stated that another contributing factor would be the need for pension plans to provide supplemental benefits to employees, especially police and firefighters, who retire before they begin receiving Social Security benefits at age 62. 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 benefits similar to those provided by Social Security because those plans would be able to eliminate duplicate benefits.

Maintaining level benefits for noncovered and newly hired employees would require states and localities in redesigning plans for the newly hired employees to adopt benefit formulas that explicitly integrate pension and Social Security benefits. For example, affected states and localities could adopt a benefit formula that offsets a portion of the member's pension benefit with a specified percentage of the member's Social Security benefit. This approach is more common in the private sector—where a 1995 BLS survey of large and medium establishments found that about

51 percent of full-time employees had benefits integrated with Social Security[12]—than the public sector, where a survey found that only about 4 percent of full-time employees had pension benefits integrated with Social Security. In the public sector, pension plans for covered employees generally recognize Social Security benefits implicitly by providing their members with lower benefit rates than are provided to noncovered employees.

Providing Benefits of Currently Covered Employees Would Likely Increase Costs

SSA estimates that about 70 percent of the state and local workforce is already covered by Social Security. The 1980 study group examined the impact on retirement costs if states and localities with noncovered employees provide newly hired employees with pension benefits that are similar to the benefits provided to employees who are already covered by Social Security. The study group concluded that implementing such formulas would increase overall retirement costs by 6 to 14 percent of payroll—or about 3 to 11 percent of payroll after deducting the Medicare tax. The study also concluded that for most pension plans, the present value of lifetime benefits for new employees covered by Social Security would be greater than the value of benefits of current noncovered employees.

As shown in table 4, our analysis of 1995 PPCC data also indicates that total retirement costs for states and localities covered by Social Security are higher than the costs for noncovered states and localities.

Table 4: Average Employee Contribution and Employer Benefit Costs for Covered and Noncovered Pension Plans

	Noncovered plans	Covered plans[a]
Employee contribution rate	8%	9%
Employer cost rate[b]	8%	12%

[a]Includes Social Security payroll tax.

[b]Excludes administrative costs and the cost of amortizing the plan's accrued unfunded liability.

Source: GAO analysis of 1995 PPCC survey data. Our methodology is described in appendix 1.

PPCC data also indicate that many employees, especially police and firefighters, retire before age 62, when they would first be eligible for Social Security retirement benefits. The data indicate, for example, that police and firefighters in noncovered plans retired, on average, at age 54. The average retirement age of other employees in noncovered plans was

[12]BLS, Employee Benefits in Medium and Large Private Establishments, 1995, Bulletin 2496 (Washington, D.C.: Department of Labor, Apr. 1998).

age 60. In covered plans, the average retirement age for police and firefighters and other employees was somewhat higher at ages 55 and 62, respectively.

Analyses indicate that, initially, the percentage of salary that is replaced by retirement income is smaller for covered employees who retire before they are eligible for Social Security benefits than for noncovered employees. Our analysis of PPCC data indicates, for example, that public pension plans replace about 65 percent of the final average salary of members who retired with 30 years of service and were not covered by Social Security. For members who retired with 30 years of service and were covered by both a pension plan and Social Security, the PPCC data indicate that pension plans replace only about 53 percent of their members' final average salary. After Social Security benefits begin, however, covered employees generally have higher salary replacement rates. For example, the average salary replacement rates in 1994 were higher for covered state and local employees than for noncovered employees, after they reach age 62 at all salary levels between $15,000 and $65,000. (See table 5.)

Table 5: Average 1994 Salary Replacement Rates in Defined Benefit Plans for Full-Time State and Local Employees Retiring at Age 62 With 30 Years of Service

Final salary	Employees covered only by pension plan	Employees covered by Social Security and pension plan: Pension plan	Social Security[a]	Total
$15,000	62%	50%	37%	87%
$25,000	62	50	31	81
$35,000	62	50	27	77
$45,000	62	50	23	73
$55,000	62	50	20	70
$65,000	62	50	17	67

[a]Excludes Social Security spousal and dependent benefits.

Source: BLS, Employee Benefits in State and Local Governments, 1994.

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.

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 group report, 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. The study stated that, 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. Regardless, the circumstances surrounding the experiences of states with covered employees make it difficult to predict what changes would occur from further extension of coverage.

Level Retirement Spending Would Mean Reduced Benefits

Several employer, employee, and pension plan representatives with whom we spoke stated that spending increases necessary to maintain level retirement income and other benefits would be difficult to achieve. State and pension plan officials noted that spending for retirement benefits must compete for funds with spending for education, law enforcement, and other areas that cannot be readily reduced. For example, Ohio officials noted that the state is having difficulty finding the additional funds for education needed to comply with court ordered changes in school financing. A representative of local government officials in Ohio stated that payroll represents 75 to 80 percent of county budgets, and there is little chance that voters would approve revenue increases needed to maintain level retirement benefits. He stated the more likely options for responding to increased retirement costs were to decrease the number of employees or reduce benefits under state and local pension plans.

If states and localities decide to maintain level spending for retirement, they might need to reduce pension benefits under public pension plans for many employees. For example, 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

- service retirement benefits were reduced (for example, salary replacement rates for employees retiring with 30 years of service would be reduced from 60.3 percent to 44.1 percent);

- retiree health benefits were eliminated for both current and future employees; and
- the funding period of the plan's unfunded accrued liability was extended from 27 years to 40 years.

The study also stated that additional benefit reductions might be needed to maintain level spending if additional investment income was not available to subsidize pension benefits for newly hired employees.

Effect on Pension Plan Finances Is Uncertain

States and localities typically use a "reserve funding" approach to finance their pension plans. Under this approach, 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 pension plan modifications would likely result in reduced contributions to public pension plans. This would occur because pension plan contributions are directly tied to benefit levels and plan contributions would be reduced to the extent plan benefits are reduced and replaced by Social Security benefits.

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, some 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 at current rates.

Actuaries also believe that reducing contributions to current pension plans could adversely affect the liquidity of some plans. In 1997, for example, an Arizona state legislative committee considered closing the state's defined benefit pension plan to new members and implementing a defined contribution plan. Arizona state employees are already covered by Social Security; however, states and localities faced with mandatory coverage might consider making a similar change to their pension plans. A March 1997 analysis of the proposed change stated that as the number of employees covered by the plan decreased, the amount of contributions flowing into the plan would also decrease. At the same time, the number of members approaching retirement age was increasing and benefit payments were expected to increase. As a result, external cash flow would become increasingly negative over time. The analysis estimated that about 10 years after the plan was closed to new members, benefit payments would exceed contributions by over $1 billion each year. In another 10 years, the annual shortfall would increase to $2 billion.

The analysis stated that the large negative external cash flow would require that greater proportions of investment income be used to meet benefit payment requirements. In turn, this would require the pension plan to hold larger proportions of plan assets in cash or lower yielding short-term assets. Once this change in asset allocation occurs, the plan would find it increasingly difficult to achieve the investment returns assumed in current actuarial analyses and employer costs would increase.

Legal and Other Considerations

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

Legal Issues

Although mandating Social Security coverage for state and local employees could elicit a constitutional challenge, mandatory coverage is likely to be upheld under current U.S. 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 Supreme 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 Supreme Court had clearly said that applying such requirements to the states was unconstitutional. States and localities also point to several recent Supreme Court decisions 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 Supreme 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.

Administrative Issues

The states would require some time to adjust to a mandatory coverage requirement. 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. The 1980 study group estimated that 4 years would be required for states and localities 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. They indicated, for example, that developing revised benefit formulas for each affected pension plan would require complex and time-consuming negotiations among state legislatures, state and local budget and personnel offices, and employee representatives.

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

Conclusions

In deciding whether to extend mandatory Social Security coverage to state and local employees, policymakers will need to weigh numerous factors. On one hand, the Social Security program would benefit from the decision. The solvency of the trust fund would be extended for 2 years, and the long-term actuarial deficit would be reduced by about 10 percent. Mandatory coverage would also address the fairness issue raised by the advisory council and simplify program administration.

However, the implications of mandatory coverage for public employers, employees, and pension plans are mixed. To the extent that employers provide total retirement income benefits to newly hired employees that are similar to current employees, retirement costs would increase. While the increased retirement costs would be phased in over several years, employers and employees would also incur additional near-term costs to develop, legislate, and implement changes to current pension plans. At the same time, Social Security would provide future employees with benefits that are not available, or are available to a lesser extent, under current state and local pension plans.

Agency Comments

SSA stated that the report generally provides a balanced presentation of the issues to be weighed when considering mandating coverage. SSA provided additional technical comments, which we have incorporated as appropriate. SSA's comment letter is reprinted in appendix II.

We are sending copies of this report to the Commissioners of the Social Security Administration and the Internal Revenue Service and to other interested parties. Copies will also be made available to others on request. If you or your staff have any questions concerning this report, please call me on (202) 512-7215. Other GAO contacts and staff acknowledgments are listed in appendix III.

Sincerely yours,

Cynthia M. Fagnoni
Director, Income Security Issues

Contents

Abbreviations

BLS	Bureau of Labor Statistics
GPO	Government Pension Offset
IRS	Internal Revenue Service
PPCC	Public Pension Coordinating Council
SSA	Social Security Administration
WEP	Windfall Elimination Provision

Scope and Methodology

To examine the implications of a decision to extend mandatory coverage to newly hired state and local employees for the Social Security program, we reviewed documents provided by SSA and IRS and held discussions with their staff. We examined SSA estimates concerning the increase in taxable payroll and Social Security revenues and expenditures attributed to extending mandatory coverage to newly hired state and local employees and discussed data sources with SSA officials. We did not assess the validity of SSA's assumptions. SSA estimates used the intermediate assumptions reported by Social Security's Board of Trustees in 1998.

To examine the implications of mandatory coverage for state and local government employers, employees, and their pension plans, we reviewed the 1980 study by the Universal Social Security Coverage Study Group, which was prepared for the Secretary of Health, Education, and Welfare at that time and transmitted to the Congress in March 1980. We discussed study results with the study's Deputy Director for Research and examined supporting documents for the study.

We also held discussions and reviewed documentation of state and local government employer, employee, or pension plan representatives in the seven states that account for over 75 percent of the noncovered payroll. We examined financial reports for nine state and local retirement systems: the California State Teachers' Retirement System, the Public Employees' Retirement Association of Colorado, the Teachers' Retirement System of the State of Illinois, the Louisiana State Employees' Retirement System, the Massachusetts State Retirement System, the Massachusetts Teachers' Contributory Retirement System, the State Teachers Retirement System of Ohio, the Public Employees' Retirement System of Ohio, and the Teacher Retirement System of Texas.

We also identified a number of states that have changed, or have considered changing, plan benefits in ways that are similar to those that might be made by states and localities with noncovered employees in response to mandatory Social Security coverage. We discussed the potential impact on plan finances of changing plan benefits with pension plan representatives in those states and examined study reports provided by them. For example, we contacted representatives of pension plans in Arizona, Kansas, Montana, South Dakota, Vermont, Washington, and West Virginia that have implemented or considered implementing defined contribution plans to replace some or all of the benefits provided by their defined benefit pension plans.

Additionally, we reviewed survey reports addressing pension benefits, costs, investment practices, or actuarial valuation methods and assumptions prepared by BLS, PPCC, and the Society of Actuaries. We discussed the implications of mandatory coverage for public pension plans with actuaries at the Office of Personnel Management, the Pension Benefit Guarantee Corporation, the American Academy of Actuaries, and in private practice.

To analyze differences between public pension costs and benefits for covered and noncovered state and local employees, we used PPCC survey data. We used the 1995 survey, which covered 1994, because the 1997 survey, which covered 1996, did not include some of the required data. Despite some limitations, the PPCC data are the best available. The data cover 310 pension systems, representing 457 plans and covering 80 percent of the 13.6 million active members in fiscal year 1994. The survey questionnaire was mailed to 800 systems, which were selected from member associations. Due to the nonrandom nature of the sample, no analysis can offer generalizations, nor can confidence intervals be calculated. Nevertheless, the survey describes the costs and benefits of a substantial majority of public pension plan members.

For our analysis of PPCC data, we classified pension plans as (1) Social Security covered if 99 percent or more of the members participated in the Social Security program or (2) Social Security noncovered if 1 percent or less of the members participated in the program. We did not adjust cost and contribution rate data to standardize actuarial cost methods and assumptions. State and local governments may have legitimate reasons for choosing various cost methods, and we did not evaluate their choice.

To identify potential legal or other problems with implementing mandatory coverage, we reviewed relevant articles and current case law. We conducted our work between September 1997 and May 1998 in accordance with generally accepted government auditing standards.

Comments From the Social Security Administration

SOCIAL SECURITY
Office of the Commissioner

July 8, 1998

Ms. Cynthia M. Fagnoni
Director, Income Security
Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. Fagnoni:

Thank you for the opportunity to comment on the General Accounting Office report, "Social Security: Implications of Extending Mandatory Coverage to State and Local Government Employees" (GAO/HEHS-98-196). We believe that the report generally provides a balanced presentation of the issues to be weighed when considering mandatory coverage for State and local government employees. We have enclosed some technical comments.

If you have any questions, your staff may contact Dan Sweeney at (410)965-1957.

Sincerely,

Kenneth S. Apfel

Kenneth S. Apfel
Commissioner
of Social Security

Enclosure

SOCIAL SECURITY ADMINISTRATION BALTIMORE MD 21235-0001

Major Contributors to This Report

Francis P. Mulvey, Assistant Director, (202) 512-3592
John M. Schaefer, Evaluator-in-Charge
Hans Bredfeldt, Evaluator

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (202) 512-6061, or TDD (202) 512-2537.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

http://www.gao.gov

PRINTED ON RECYCLED PAPER