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Subcommittee on Social Security, Pensions and Family Policy

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from Work Not Covered by Social Security"
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Mr. Chairman and members of the subcommittee:

I am pleased to have the opportunity to discuss with you the public policy problems arising because certain employers do not currently participate in the Social Security program.[1] I will discuss the nature and scope of these problems, the approaches Congress has taken previously to deal with similar problems arising in other contexts and the suggestions that have been made to deal with the current issues.

Social Security covers some 96 percent of the American workforce. By far, the largest block of workers not covered are certain employees of state and local governments whose employers have decided to not participate in the program. There are some five million of these workers and they constitute some 30 percent of all of the employees of state and local governments. The other 70 percent of state and local employees participate in social security on the same basis as do all other workers covered by the program. All state and local employees participate in the Medicare program.[2]

The 30 percent that are not covered by Social Security are not a random set of all state and local employees. Three-quarters of them are from one of seven states -- California, Colorado, Illinois, Louisiana, Massachusetts, Ohio and Texas. In addition, they are more likely to be police, firefighters or teachers.

All of the state and local employees not covered by Social Security are instead covered by a pension plan operated by their state or local government. These pension plans tend to be more generous than Social security in some respects and less generous than Social Security in other respects. One way in which they are more generous is that they tend to offer higher benefits than Social Security would pay, at least at the time the

[1] The views expressed are my own and not necessarily those of the Urban Institute or its officers or funders. I follow the common practice of using "Social Security" to refer to the Old-Age, Survivors' and Disability Insurance program.
2 Coverage figures are from a 1998 GAO report entitled **Social Security**: Implications of Extending Mandatory Coverage to State and Local Employees HEHS-98-196 August 18, 1998.

individual retires. In part, these more generous benefits reflect the fact that the single pension plan operating by a non-covered employer must take the place of two pension plans that are available to similar employees who are covered by Social Security, namely Social Security itself and a supplemental pension plan that most covered state and local governments provide their employees.

A second way in which non-covered pensions are typically more generous involves the age at which benefits are first payable. Plans covering police and fire inevitably allow retirement prior to 62, Social Security's earliest retirement age, frequently after only 20 or 25 years of service. Other state and local plans commonly allow retirement as early as age 55 for employees with long service.

One area in which Social Security is more generous involves adjustments for inflation after retirement. State and local plans (whether or not the employer participates in Social Security) are far more likely to have some form of inflation adjustment than are private sector defined benefit pensions, but it is common for them to cap annual adjustments at two or three percentage points. Social Security adjustments are not capped. As a result of this difference, the gap between the actual retirement benefit from the non-covered employer and the social security benefit that its employees would otherwise have received can grow narrower the longer the individual is retired.

A second area where Social Security is often more generous involves benefits to workers (and/or their families) who die or become totally disabled before reaching retirement age and as a result of factors unrelated to their employment. The gap is likely to be particularly large for relatively young workers. One calculation prepared at the time that social security coverage for federal civilian employees was being debated found that monthly Social Security survivor and disability benefits for a 31 year old worker would be about twice as high as the survivor and disability benefits paid under the Civil Service Retirement System.[3]

The fact that several million state and local employees remain outside of the Social Security program produces several kinds of public policy problems. They arise, in part, because the Social Security program has been designed to redistribute from those with higher lifetime average earnings to those with lower lifetime average earnings and from single individuals to families. Higher wage employees in non-covered employment do not share in the burden of financing the redistribution to lower wage earners. It's as if we decided to exempt 5 percent of the population from paying the progressive income tax and subjected them, instead, to a flat tax with one marginal rate. Of those who found themselves under the flat tax, higher wage workers would win while lower wage workers may well lose.

Another set of policy problems arises because many people who work in non-covered employment for a large part of their careers also have spells where they work in employment this is covered by Social Security and/or have spouses that work under Social Security. In the late 1990s, the Social Security Administration (SSA) estimated

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[3] Report of the 1979 Advisory Council on Social Security, p . 148.

that between 50 and 60 percent of those working in non-covered employment would have enough coverage from other jobs (held before, after or simultaneously) to qualify for Social Security retired worker benefits by the time they reach age 62 and most of the rest would become eligible to receive Social Security survivor or dependent benefits on the basis of a spouse's earnings record.[4]

The Government Pension Offset and Windfall Elimination Provision are designed to prevent persons receiving pensions from non-covered employment from being treated as if they had lower pension income or lower pre-retirement earnings than was actually the case. They attempt to prevent these persons from benefiting from Social Security's redistributive features to a degree that similar colleagues whose work was covered by Social Security would not benefit. Each, however, is an imperfect instrument and the result is, at best, rough justice.

A third set of policy problems involves gaps in benefit protection for workers that move into and out of non-covered employment. Workers who either die or become disabled before reaching retirement age are particularly vulnerable to coverage gaps produced by such job changes. Job changers can also experience benefit loss if their work under one of the two systems turns out to be of insufficient tenure to qualify them for a benefit.

Under Social Security, the family of a worker dying before reaching retirement age is not eligible for survivor benefits unless the worker was either "fully" or "currently" insured. The former requires a quarter of coverage for each year elapsing since the worker turned 21 and the latter requires at least 6 quarters in the last three years. People who work for 20 years in non-covered employment and decide to change to jobs covered under Social Security would likely lose any pre-retirement survivor protection from their former employer as soon as they left that job but would not qualify for protection under Social Security until they had worked at least a year-and-a-half for their new employer. Even then, their Social Security benefits would be quite low because their lifetime Social Security average earnings would be so low. The impact of job changes on disability protection is even more significant, since disability benefits are available only to people who are both "fully" insured and (except to the blind) "disability" insured. The latter generally requires Social Security earnings credits in five of the previous ten years. Mid-career job changers are likely to loose their disability insurance protection for five or more years after their job change.

These various policy problems can only be addressed adequately by either bringing those employees that are not now under Social Security into the program or by creating a system for exchanging credits between Social Security and the non-covered employers that allows two separate plans to provide coordinated benefit protection. History provides an example of the use of each approach in resolving similar problems with respect to employees in other sectors.

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[4] GAO, 1998.

Congress used the former strategy to eliminate coordination problems arising with respect to federal civilian employees. Prior to 1983, most federal civilian employees were not covered by Social Security, giving rise to all of the same sort of problems as have been noted here with respect to non-covered state and local employees. In 1983, the Congress decided that civilian employees hired after that year would be covered by Social Security and that they would also participate in a redesigned supplemental pension program. The new pension program, a combination of the Federal Employees Retirement System (FERS) and the Federal Thrift Savings Plan (TSP), provided generally lower benefits than had been provided under the previous regime, largely to reflect the fact that they were to be a supplement to -- rather than a replacement for -- Social Security. By 2015 or 2020, virtually the entire federal workforce will be covered by Social Security.

Congress used the other strategy to eliminate similar coordination problems arising with respect to railroad employees. As with the Civil Service Retirement System, the Railroad Retirement System was established before Social Security was created and, as a consequence, railroad employees have never been covered by Social Security. Coordination problems of the type described here were eliminated in 1973, however, when the Congress restructured the railroad retirement package and improved the coordination between the railroad system and Social Security. The Railroad Retirement benefit is now divided into two tiers. Tier I essentially duplicates the Social Security benefit, while Tier II is a supplemental pension that plays the same role for railroad workers as employer-provided pension plans play for private sector workers and FERS/TSP plays for federal employees. Tier I is financed in exactly the same way as Social Security is financed and Tier II is financed entirely from employer contributions. At the time of their retirement (or death or disability), those who have worked under both Social Security and Railroad Retirement have their credits under the two programs combined. The combined credits are used to determine whether workers are eligible for benefits and, if eligible, for calculating the amount to which they are entitled. The cost of paying the benefits is split between the two systems roughly in proportion to the amount of the earnings credits coming from each of the two systems.

Recent discussions of changing the coverage rules under Social Security seem always to assume the use of the first of these two strategies. Specifically, a number of people who have offered specific plans for closing Social Security's long run financing gap include as one part of their plan the extension of coverage to all newly hired employees of those state and local employers that do not now participate in Social Security. Such a provision has a positive impact on Social Security finances since the newly covered workers (and their employers) pay Social Security contributions as soon as they start working but do not begin to draw benefits until (for the most part) many years later. Averaged over the next 75 years, the SSA has estimated that this change would reduce the long-run deficit by 0.22 percent of payroll, or about 11 percent of the total projected deficit. The positive impact is, however, temporary. By the end of the projection period, there is very little net benefit to Social Security as the additional annual benefit payments have risen to almost the same level as the additional annual contribution income.[5]

From the explanation given by most of those advocating such a change, one gets the impression that these proposals are motivated more by the desire to improve the financial condition of Social Security than to improve the coordination of benefits between Social Security and the currently non-covered employers. I believe that this is unfortunate. Opponents can criticize such proposals as simply a blatant attempt to improve the financial status of Social Security at the expense of the financial well being of affected state and local governments, obscuring the very real issues that non-covered employment raises for both covered and non-covered workers.

Opponents of extending coverage often note the size of the additional Social Security contributions that would have to be paid and imply that this is a new net cost that would have to be borne by the governmental unit's taxpayers. More thorough analyses of the probable impact on those units not now covered suggest that this is, almost literally, a half-truth. If the governmental units impacted by the change adjusted their benefit package so that new hires would get as much from the combination of Social Security and a supplemental pension as they would have received from the non-covered pension alone (including similar benefits for those retiring before age 62), the new package would increase total pension costs by some 6 to 7 percent of payroll, essentially half of the amount that the entities would be paying in newly imposed Social Security contributions.[6]

The fiscal impact on the newly covered governmental units is the net of several offsetting factors. Although these employers must start making payments to Social Security, they can also reduce their contributions to their own pension plans, since their plans' future benefit liabilities can be reduced by the amount that Social Security will be paying to the newly covered workers. In a simple world, a world in which Social Security's benefits were structured in the same way that the non-covered pensions were structured and in which the non-covered employer's pension plan was fully funded, the transactions would wash. The reduction in future pension liabilities would exactly offset the increased payments to Social Security leaving the financial position of the governmental entity unchanged.

You'll not be surprised to learn, however, that we don't live in a simple world. At least three factors have the effect of increasing the total cost borne by newly covered governmental units. First, many of them have unfunded liabilities in their current pension plans, so that the reduction is future liabilities is not quite enough to offset the revenue being diverted to the Social Security program. In effect, they needed a portion of those current contributions to help cover the cost of prior benefit promises.

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[5] These estimates are based on the 2005 Trustees' Report assumptions and are available on the Social Security web site (on November 1, 2007: http://www.ssa.gov/OACT/solvency/provisions/index.html)

[6] GAO, 1998

Second, apparently state and local government earnings are, on average, higher than the earnings in the rest of the economy.[7] This means that, if they are required to participate with the rest of the country in the redistribution built into the Social Security program, they will be net losers. (Shifting them from their flat tax to the progressive tax paid by everybody else will cause their tax liability to rise, at least on average.)

Finally, remember that the Social Security package is superior in some respects to the packages now offered these state and local governmental employees. If the combination of their new, supplemental pension plan and their Social Security coverage matches all of the benefits that they would have received previously, the additional features from Social Security will result in a package that is both more valuable to the employees and more expensive to their employers. Apparently, taken together these three factors offset about half of the amount saved from the reduced future pension payments.

My own view is that the better approach to improving coordination between Social Security and those governmental units not now covered by the program is through an exchange of credits approach. Under this approach, those state and local employees not now covered by social security would, in the future, be entitled to a social security benefit. As is currently the case with railroad workers, that benefit would be based on all earnings, both those from their currently uncovered employer and those from other employers that do participate in Social Security. The benefit could be paid either through the Social Security Administration or through their employer's pension organization. Its cost would be shared by their employer and SSA in proportion to the indexed earnings recorded under the respective programs.

Those employers not currently participating in Social Security could decide how they wanted to adjust to this new regime. They may want to take the opportunity to restructure their pension and convert it to a purely supplemental pension. Or, they may decide simply to deduct the amount being paid as a Social Security benefit (or, alternatively, that portion attributable to earnings from employment with them) from what they would otherwise have paid, guaranteeing that their employees would be no worse off. The change could be applied only to new hires, or (depending on how the current pension plan is adjusted) it could be applied to those currently working for the affected state and local government units, to the extent that sufficient earnings records exist to implement the plan.

A reform such as this would allow us eventually to get rid of both the Government Pension Offset and the Windfall Elimination Provision and of the errors introduced by the roughness of the justice each introduces. At the same time, it must be

[7] The average worker covered by Social Security earned about $38,600 in 2006. Although few people will get rich working for state and local governments, a majority will earn more than that amount. The SSA estimate of the impact of extending coverage was that in 2080 new contribution income would be ever-so-slightly above additional benefit payments. At the same time, the 2007 Trustees' Report estimates that the contribution income from the rest of the population will cover only about 70 percent of the cost of benefit payments in 2080.

acknowledged that the reform would not be costless to affected state and local governments (and/or their employees).

The reform I suggest has the advantage of assuring that additional costs imposed on state and local governments are not merely – or do not appear to be merely – changes motivated by a desire to improve the finances of the Social Security program. In fact, they will do very little to improve that program's finances. Rather, the additional costs would be, in part, the cost of improving the benefit protection afforded their own employees in those areas where Social Security is now superior. They would also be the costs associated with participating fully in the system for assuring a more adequate retirement income to those who labored most of their lives at low wages.

I think that this last factor is a fair burden for us to ask all of the currently non-covered employers to bear. In the end, we're all in this together.