

WORKING PAPER

Executive Summary

MAY 2014, WP 2014-9

CENTER *for*
RETIREMENT
RESEARCH
at BOSTON COLLEGE

THE IMPACT OF MANDATORY COVERAGE ON STATE AND LOCAL BUDGETS

BY ALICIA H. MUNNELL, JEAN-PIERRE AUBRY, AND ANEK BELBASE

Social Security's trust fund is scheduled for exhaustion in 2033, so Congress will soon be pressed to take action to restore solvency. One proposal in virtually every package to eliminate the program's shortfall is the extension of mandatory coverage to newly hired uncovered state and local workers. This paper assesses the arguments for and against this option, with a focus on estimating the potential cost impact on public employers and employees.

While extending Social Security coverage to more state and local workers would modestly reduce the program's 75-year imbalance, the most compelling arguments in favor of the proposal have little to do with finances. Rather the case rests on equity for all U.S. taxpayers and on ensuring that state and local workers have access to the benefit protections offered by Social Security. The equity issues are twofold. First, advocates of universal Social Security coverage contend that uncovered workers should share in the cost burdens associated with the program's redistribution of income to workers with low lifetime earnings and with the program's legacy cost. With respect to improved benefits under Social Security, state and local workers would gain improved disability insurance, dependent and survivor benefits, portability, and full inflation protection.

The main argument against extending Social Security coverage is the additional cost to public employers and their employees. Prior studies – most prominently those for the 1980 Study Group established by the Secretary of Health, Education, and Welfare – have estimated the average cost increase under the assumption that public employers would reduce their own plan benefits so that the combined Social Security/public pension benefit would equal the average worker's initial benefit under the existing system.

Much has changed since 1980. Public plan benefits have become more generous, and the cost of Social Security has also increased substantially. Public plan sponsors pay more attention to funding, and, in the wake of the financial crisis, they may select less liberal integration schemes than they have in the past. And the portion of Social Security payroll taxes that go toward the system's legacy costs has been isolated and quantified. Finally, it is important to look beyond the increase in plan costs to the impact on overall public finances in the affected states. This paper builds on previous research by presenting an updated and more comprehensive cost analysis for 22 uncovered plans in 13 states and covers four different strategies for integrating Social Security with public pensions:

- 1) No adjustment to current state defined benefit plan; Social Security costs are simply added to defined benefit (DB) costs.
- 2) Current DB plan benefits and costs are reduced by an amount that preserves first-year benefits for the average employee.
- 3) Current DB plan benefits and costs are reduced by an amount that preserves lifetime benefits for the average employee.
- 4) Current DB benefits and costs are reduced by an amount that is similar to adjustments made in surrounding states with Social Security coverage.

The costs are based on the discount rates currently used by states and localities. These rates are viewed as too high by economists because promised benefits are discounted to the present using the long-run expected return on plan assets rather than a rate that more accurately reflects the riskiness of the promised benefits. Therefore, this approach understates state and local pension costs and overstates the budgetary impact of introducing Social Security coverage. Nevertheless, the calculations are based on these optimistic assumptions because plan sponsors will use their own assumptions when making decisions about the impact of Social Security.

The goal is to measure the short, medium, and ultimate impact on plan costs and state budgets of extending Social Security coverage to the workers in the 22 plans. The study also assesses the impact on the overall budget for each state by combining the costs for public plans that already have such coverage with the uncovered plans considered in the analysis.

Calculating pension costs under the different integration strategies involves three steps. The first is to project first-year benefits and lifetime benefits for the average worker under the state's DB plan. An average worker is defined by the average age, tenure, and salary of workers in a plan. The worker's projected initial benefit is calculated using the expected retirement age, salary, and tenure based on the plan's own benefit provisions and its actuarial assumptions for withdrawal, retirement, and salary growth. The estimate of lifetime benefits is calculated by applying the plan-specific COLA increases and post-retirement mortality assumptions.

The second step is to project initial and lifetime benefits for the average worker under Social Security. The initial Social Security benefit at retirement is derived by applying the program's benefit formula to the worker's Average Indexed Monthly Earnings based on the highest 35 years of earnings. The value of lifetime benefits reflects Social Security's inflation protection, spousal and survivor benefits, and plan-specific mortality for the average worker.

The third step involves calculating the offset to DB benefits and normal costs under the four different integration strategies. To estimate this offset, Social Security benefits for the average worker are first calculated as if their state and local earnings were covered. We compare Social Security benefits – initial and lifetime – to DB benefits. DB benefits are then decreased to account for additional Social Security income, thereby fully offsetting any increase in total retirement benefits from Social Security coverage. Normal costs for the pension plan are reduced by the same proportion as the decrease in pension benefits.

The aggregate results show a potentially wide range for the additional cost of Social Security coverage. But the most likely path is to match first-year benefits, which would raise costs as a percent of payroll by about 6 percentage points. In addition, the costs for Social Security's Disability Insurance program – not considered here – will raise costs by approximately another 1 percent.

Presenting the additional costs as a percent of payroll may exaggerate their burden on the employer as the increases will likely be split between employer and employee. This analysis thus also estimates the size of the cost increase as a share of a state's budget. For states with uncovered plans, pension costs as a share of total own-source revenue are likely to rise by approximately 1 percent as a result of the extension of Social Security coverage to new hires.

As discussed above, even this calculation exaggerates the true burden due to the fact that state-local pension costs are understated. If the calculations were done using a rate that reflects the riskiness of the promised benefits, the addition to plan costs would arise primarily from Social Security's legacy costs – roughly 3 percent of payroll. If this cost were split between employer and employee, the impact on state and local budgets would be trivial.

© 2014, Alicia H. Munnell, Jean-Pierre Aubry, and Anek Belbase All rights reserved. The research reported herein was performed pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium (RRC). The opinions and conclusions expressed are solely those of the authors and do not represent the views of SSA, any agency of the federal government, the RRC, or Boston College.

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

Hovey House, 140 Commonwealth Avenue, Chestnut Hill, MA 02467-3808

phone 617.552.1762 fax 617.552.0191 crr@bc.edu crr.bc.edu