Report of the Universal Social Security Coverage Study Group: Executive Summary*

Authorized under the 1977 amendments to the Social Security Act, the Universal Social Security Coverage Study Group was established at the direction of Congress by the Secretary of Health, Education, and Welfare in 1978. Its 2-year mission was to examine the feasibility and desirability of mandating coverage under the social security program for Federal workers and for noncovered employees of State and local governments and private nonprofit organizations. The group reviewed the coverage held by workers who would be affected, developed options for and alternatives to mandatory coverage, analyzed the effects of each option and alternative, and consulted with other Government agencies and with members of the public. To assess public attitudes, testimony was received from private citizens, public officials, and representatives of interested organizations at public hearings held in seven locations. In the following executive summary, sections refer to chapters in the full report.

Section 1. Introduction

The Universal Social Security Coverage Study Group, established in 1978 by the Secretary of Health, Education, and Welfare at the direction of Congress, was charged with the task of examining the "feasibility and desirability" of legislating mandatory coverage for noncovered workers. To accomplish this task, the Study Group was directed (1) to review the extent of coverage of employees at all levels of government and in nonprofit organizations; (2) to develop options for and alternatives to mandatory coverage; (3) to analyze the organizational, fiscal, and legal effects of each option and alternative; and (4) to consult with other Government agencies and with members of the public.

Universal Social Security coverage has been debated since the Social Security program began in 1935. Proponents argue that without universal coverage, inequities and problems arise for both individual workers and the Social Security system. Specifically, noncovered workers who move between covered and noncovered jobs are exposed to gaps in survivor, disability, and postretirement medical coverage. The Social Security system suffers because workers who spend much of their careers in noncovered employment can also obtain minimum Social Security coverage through part-time employment. These individuals profit from a benefit structure that was designed to help low-wage workers rather than workers whose second careers entitle them to benefits. Noncovered workers, finally, can avoid paying their share of the redistributive costs of Social Security.

Opponents of coverage argue that efforts to eliminate the inequities may create additional problems and inequities in several areas, including benefit levels, retirement program costs, and administrative burdens for the employees and retirement systems that would be covered.

Since the Social Security program began, Social Security Advisory Councils, Retirement Committees, and Commissions have been formed to study various aspects of the program. In general, these groups have recommended extending Social Security to cover all employment or, at a minimum, improving coordination between noncovered systems and Social Security to reduce inequities in the current program. These advisory bodies, however, have not discussed the costs and procedures involved in extending coverage or in achieving coordination, especially for State and local government employees.

The current study differs from earlier studies in several ways. This is the first study that has attempted to quantify the issues and to provide detailed, empirical analyses of the principal alternatives. These analyses yielded substantial information about how individuals would be affected under

*For further information on the study, see **The Desirability and Feasibility of Social Security Coverage for Employees of Federal, State, and Local Governments and Private, Nonprofit Organizations: Report of the Universal Social Security Coverage Study Group,** Department of Health, Education, and Welfare, March 1980.

each alternative. The report also quantitatively assesses the problems resulting from the lack of mandatory Social Security coverage.

In examining the issue of mandatory coverage, the Study Group focused on four main options: (1) maintenance of the status quo, (2) increases in incentives for voluntary participation in Social Security, (3) alternatives to mandatory coverage that would close coverage gaps and reduce windfalls, and (4) approaches to mandatory coverage. Of the four, the last two emerged as the most significant and are discussed at length.

Alternatives to mandatory coverage include revising the Social Security benefit formula, providing for credit transfers between noncovered retirement systems and Social Security to reduce windfall benefits, and establishing minimum standards for all public employee retirement systems through legislative initiatives. Approaches for mandatory coverage could involve new employees only, new employees and some current workers, or all current workers. Each of these variations has been considered in the context of coordinating current, noncovered retirement plans with Social Security by revising the existing plans to give workers the advantages of both pensions.

Section 2 reviews the background and current status of the Social Security program and of pension plans in American society today. Section 3 discusses the inequities resulting from existing exemptions in the Social Security program. Section 4 examines the major options involved in addressing the issue of mandatory Social Security coverage, including alternatives to coverage. The next three sections consider the effects of mandatory coverage and of alternatives to such coverage for employees of the Federal Government (section 5), State and local governments (section 6), and nonprofit organizations (section 7). In accordance with the Study Group's mandate, the final section discusses the feasibility and desirability of mandatory Social Security coverage.

Section 2. Background and Current Status of Retirement Income Systems

When established in 1935, the Social Security program—the national system of social insurance—was compulsory for all private sector workers in commerce and industry who were younger than age 65. Since then, the program has expanded to 9 out of 10 American workers, including self-employed workers, professional workers, members of the clergy, and some government employees at Federal, State, and local levels.

Social Security provides old-age, survivors', and disability insurance to all workers insured by 40 quarters of coverage employment. All benefits are subject to an earnings test, which limits only the amount of earnings from current work. No means test, or examination of assets, is involved. Benefits are exempted from Federal income taxation, are increased to keep pace with inflation, and are based on earnings.

Pensions

Pensions vary from employer to employer. While pensions cover almost all workers in the public sector, only about half of the private sector workers have pension protection beyond Social Security. Employers are not required to establish pensions, but if they do, their plans must conform to various Federal standards. Pensions are regulated by the Department of Labor, the Pension Benefit Guarantee Corporation, and the Internal Revenue Service.

There are two types of pensions: the defined contribution plan and the defined benefit plan. Defined contribution plans are usually funded by employer contributions based on an employee's earnings each year. The amount of benefits received depends on accumulated contributions and interest. These pensions are seldom indexed, and their value erodes quickly during periods of inflation.

In defined benefit plans, an employee usually contributes a percentage of his or her salary to the pension fund. Benefit amounts are based on length of service and recent earnings. Typically, the employer's share of costs is greater than the employee's share. Eligibility standards set both age and length-of-service requirements. Defined benefit plans in the public sector generally provide some protection from inflation. Almost all public sector employees participate in this type of plan.

Coordinating Pensions and Social Security

Virtually all public employee retirement systems subscribe to the philosophy that benefits should be directly and proportionally related to previous earnings. In the Social Security system, benefits are related but are not directly proportional to previous earnings.

Public employee plans and Social Security differ in two fundamental respects. The public employee benefits sometimes cover only part of an employee's career and generally are paid in direct proportion to final earnings. Social Security covers earnings throughout the career and pays benefits that are based on, but not strictly proportional to, average career earnings. Several other, lesser differences between Social Security and public employee benefits exist.

Although these differences are important, they are not significant obstacles to coordination. Social Security and pension plans can function in tandem, each operating according to its benefit principles and structures, as demonstrated by private sector staff plans and by covered State and local government plans.

The Railroad Retirement System

The Railroad Retirement System is the only instance of a federally legislated retirement plan that covers private sector employment. Although they are not covered by Social Security, railroad workers receive retirement benefits that are integrated with Social Security. A financial exchange also takes place between the two systems.

This complicated system is not the perfect policy model. Nonetheless, the Railroad Retirement System demonstrates that it is possible to resolve some of the problems that result from the lack of mandatory Social Security coverage without actually imposing coverage.

Section 3. The Bases for Considering Mandatory Social Security Coverage

Although the Social Security program now covers almost all American workers, certain inequities and inadequacies result from the existing pattern of exemptions from the program. The five major issues are as follows:

(1) Gaps in insurance protection exist for workers moving between jobs that are covered and jobs that are not covered by Social Security.

(2) Gaps in benefit protection exist for workers in noncovered employment.

(3) A few workers are exempted from paying into a redistributive program that provides proportionately more generous benefits to low-wage than to high-wage workers.

(4) Participation in noncovered employment exempts part of the lifetime earnings of some workers from Social Security taxes. These workers subsequently receive a Social Security benefit—often called a windfall—that is high in proportion to the payroll tax they paid.

(5) Some workers who spend most of their careers in noncovered employment also work for a short period in the covered sector without becoming fully insured under Social Security. These individuals receive no retirement benefits from Social Security based on their contributions to the program.

The issues are discussed separately in this section, but the problems are interrelated. In addition to considering the inequities inherent in the existing system, the section examines the implications of expanded coverage for the Social Security system.

Insurance Gaps

Gaps in insurance protection arise because both Social Security and the typical staff pension plan require a period of employment before workers become eligible for benefits. As a result, workers who have noncovered jobs or who shift between covered and noncovered employment may experience periods without disability and survivors' protection.

Gaps in insurance coverage for Federal workers occur because every year large numbers of employees leave Federal employment and a stream of new employees and reentrants replaces them. The Federal workers who are most affected by insurance gaps are those in their first 5 years of Federal service and those who leave Government service before becoming eligible for an annuity.

Many employees in the initial 5 years of service are young people holding their first major jobs who have no other pension protection. Although disability is unlikely for most workers in this category, when it occurs the affected individual is often without insurance and assets.

Workers who leave Federal employment without CSRS (Civil Service Retirement System) annuity status have the least Social Security coverage and are the most likely to need it. Of workers who left between 1973 and 1977, on average, 39 percent of the men and 63 percent of the women are not insured against disability. Even the most vigorous opponents of mandatory Social Security coverage acknowledge that these insurance gaps warrant modifying the current system .

The effects of lack of Social Security coverage on insurance protection cannot be analyzed for State and local government employees because no data comparable to those for Federal workers exist. The extent of the "gap" problem depends on work force turnover rates in those State and local plans that are not covered and on the provisions of the various plans.

Gaps in Benefit Coverage

Workers in noncovered employment also experience gaps in benefits. These gaps arise because many of the noncovered pension systems do not provide disability and survivors' benefits comparable to those provided by Social Security. A 21-year-old worker can acquire Social Security disability protection with 18 months of work in covered employment. The same person would have to work 5 years for the Federal Government to become insured under CSRS. Many noncovered State and local systems require even longer periods of coverage to qualify for disability benefits. Furthermore, staff benefit levels often are inferior, especially for young workers with families.

The partial gaps in coverage extend beyond disability and survivors' protection. A comparison of covered and noncovered State and local pension plans shows that the combined benefits of covered systems generally exceeded the benefits of noncovered systems by 20 to 60 percent in 1976. Given the fact that Social Security benefits are not taxable, the disparity between the annuities of covered and noncovered plans is even more marked.

In addition, dependents' benefits are usually more generous under Social Security than they are under noncovered plans. Social Security provides better spouse benefits and cheaper medical protection than virtually all noncoordinated systems. Social Security benefits are fully indexed to changes in the cost of living, whereas the benefits of most noncovered plans are not. Thus, these gaps make all noncovered workers and their families vulnerable.

Redistributive Inequities

Social Security benefits are tilted in favor of low-wage earners; the system is redistributive. The Study Group found nothing to suggest that employees of government and nonprofit organizations deserve exemption.

Low-wage earners in noncovered employment, including disproportionate numbers of women and minority workers, would benefit from coverage; full-career high-wage earners would be adversely affected by coverage.

Benefit and Contribution Inequities

Workers in noncovered employment who also qualify for a Social Security benefit enjoy the advantage of receiving higher benefits from Social Security in proportion to their contributions to the system. Workers who spend most of their careers in the covered sector but have a segment in noncovered employment also receive these relatively higher benefits. This advantage, often labeled a "windfall" benefit, is more properly characterized as an "unintended subsidy."

Windfall benefits for dual beneficiaries currently are estimated to cost the Social Security system about $840 million a year. An additional $1.1 billion a year is lost because of gaps in contributions from employees who are currently noncovered. These employees will not receive a pension from that noncovered employment but will receive Social Security benefits that are disproportionately high compared with their contributions.

Effects of Mandatory Coverage on Selected Groups

Pension coverage for several groups of workers now in noncovered employment would be substantially enhanced if their pension plans were coordinated with Social Security. Minority groups having disproportionately large numbers of low-income workers would find the redistributive aspects of Social Security to their advantage. The tilt in Social Security benefits would almost certainly increase pensions for low-income wage earners.

Women also would benefit from several aspects of wider Social Security coverage. Approximately 28 percent of women employed by the Federal Government in April 1978 had annual salaries below $10,000, compared with 7 percent of male Federal employees.

Approximately 1 million Federal workers have military service for which they can receive credit under CSRS. However, CSRS benefits are reduced when the veteran reaches age 62 if he or she is eligible for Social Security and if the military service occurred after 1956.

If Social Security coverage were extended to Federal workers, military service could still be used to determine both Social Security and CSRS benefits. Then, reducing CSRS benefits at age 62 would no longer be appropriate because the new CSRS formula would automatically coordinate the benefits.

Effects of Mandatory Coverage on the Social Security Program

The effects of mandatory coverage on the Social Security program would depend on the groups for which Congress enacted coverage. Congress sets Social Security taxes to maintain an approximate balance between revenues and disbursements, plus a modest reserve fund.

If coverage were expanded to all noncovered workers, Social Security disbursements would increase gradually. Initially, these increases would be quite small because the newly covered workers would not be eligible to retire for some time. These increases in disbursements would be more than offset by increases in revenues generated by the expanded coverage. If all currently exempted workers were covered at once, new Social Security revenues would substantially exceed disbursements for the first years.

Because workers and their employers would begin to pay taxes before the workers become eligible for benefits, the short-term effects of coverage are much more positive for the system than are the long-term effects. The short-term effects would be more limited if mandatory coverage were limited to workers hired after the effective date.

The Social Security Administration estimates that in the long run mandatory coverage would make possible a reduction of 0.5 percent in the Social Security tax rates paid on the total covered payroll. This reduction would constitute savings of approximately $6 billion a year in current dollars, for currently covered workers.

Effects of Mandatory Social Security Coverage on Affected Jurisdictions

Substantial increases in Social Security revenues could not occur without causing reverberations in previously noncovered systems. Some people have argued that coverage would add to the financial burdens of the affected jurisdictions. However, virtually all employees and employers in the private sector and two-thirds of those in the public sector now participate in the Social Security program and bear the financial burden of the payroll tax.

Any approach that required additional cash outlays from a jurisdiction and its employees would have its sharpest effect on public plans that do not advance-fund. The local jurisdiction that does not advance-fund would bear the combined costs of Social Security and the existing retirement system until employees began to retire under the coordinated system. This financial burden would exist even if the benefit accrual rate for future service of current employees were reduced.

Systems with advance-funding would be in a different position. To the extent that Social Security provides some benefits that overlap with the current plan, the public employee retirement system could be redesigned so that future obligations would accrue at a lower rate. The new, lower rate at which public employee retirement benefits accrued could be immediately reflected in a new, lower contribution rate to the retirement system.

Section 4. Options

Public policymakers have two principal choices in addressing the problems in the Social Security program: to mandate coverage for some or all workers in noncovered employment or to reduce coverage gaps and undesirable subsidies (windfalls) without mandating coverage.

Extension of Social Security coverage would be the most effective way to resolve the gaps and windfalls issue. Initially, however, mandatory coverage could be partial rather than universal. Coverage could be extended to all or only one of the major noncovered sectors, and directed toward only new employees or to all or some of the current workers within those sectors. Coverage could be mandated immediately for one group but phased in for others.

The second approach would be to reduce the problems of insurance gaps and windfalls without requiring Social Security coverage. A system for transfer of retirement credits could be established between Social Security and noncovered retirement systems to reduce coverage gaps for most people who enter or leave noncovered employment. To eliminate at least some coverage gaps, mandatory minimum standards could be imposed on noncovered retirement systems. Social Security benefits of individuals with some noncovered employment could be adjusted to remove or reduce windfall benefits. The option to withdraw from Social Security now available to State and local governments could be eliminated to help prevent the gaps and windfalls problems from worsening.

A third, less practical option would be to increase voluntary coverage incentives. If monies for Social Security revenues were raised by means other than, or in addition to, the payroll tax, voluntary coverage would be encouraged because the burden of the additional taxes would fall equally on covered and noncovered workers. However, if other sources of revenue—such as value-added taxes—were made available to the program, the effects would extend well beyond the mandatory coverage issues and beyond the Study Group's charter.

Another option would be to continue the status quo. The Study Group found no support for this course, which would mean continuation of windfalls and coverage gaps. Other options, such as making Social Security voluntary for all, eliminating the welfare components of Social Security, or eliminating Social Security altogether, were not considered as part of the Study Group's mandate from Congress.

Mandatory Coverage

If Social Security coverage were mandated for Federal, State, and local government employees, most current retirement benefit formulas would need revision. Future retirees would get one part of total benefits from the Social Security system and another from staff benefit systems. The way in which benefits were coordinated would affect the distribution of total benefits among employees with different career patterns.

In all approaches, benefits would be based on length of service and final salary. A benefit accrual rate of between 1 percent and 2 percent would be multiplied by the number of years of service. This percentage would then be applied to the worker's final salary to determine the pension amount. Final salary could be the previous year's salary or the average of the previous several years.

In the **add-on approach,** the amount of the staff benefit would not be affected by the amount of the Social Security benefit. In the **offset approach,** the staff benefit would be reduced by a variable percentage of the Social Security benefit. In the **step-rate approach,** a given percentage would be applied to salary below a specific amount and a higher percentage to all salary above it.

Each approach could be designed to provide average employees with the same retirement income, including Social Security, that the present noncovered systems provide. Of the three approaches, the add-on is the most advantageous to low-income workers. The others partially counteract the progressive nature of Social Security and are, therefore, more advantageous to higher-income workers.

Transitions

The transition method chosen to implement mandatory coverage would determine which employees would be covered and which would be exempted and would determine the time that would be required to implement coverage. The chief transition goals would be equity and administrative efficiency. General transition strategies range from including everyone immediately to including only new employees. The Study Group concentrated on a middle strategy that would exempt some current workers and provide prospective coverage for all others. Given the diversity in career patterns, constructing a transition threshold on a combined age and service criterion might be reasonable. The combination could give workers a reasonable time to accrue Social Security coverage before retirement.

"Hold harmless" provisions could be implemented to protect current employees' present benefit accrual rates under the new, coordinated pension plan. Specific hold-harmless proposals for Federal workers are explored in the full report.

Alternatives to Mandatory Social Security Coverage

Alternatives to mandatory Social Security coverage include revising the Social Security benefit formula to reduce windfall benefits and establishing minimum standards or transfer-of-credit plans for public employee retirement systems to reduce coverage gaps. Reducing windfalls would require changing the way Social Security treats workers in noncovered employment. Credit transfers and minimum standards would requrie modification of currently noncovered pension plans.

The Study Group analyzed five strategies to reduce windfalls, and chose the following evaluation criteria for assessing alternative strategies: retention of the Social Security tilt, retention of presumed need, no variations in treatment, no spillover effects, administrative simplicity, and prospective application. Using these criteria, the average replacement method emerges as most reasonable; workers would receive the same relative benefit that they would receive if all their earnings were covered.

Closing Protection Gaps

Insurance gaps that result from inadequate public employee retirement system benefits could be reduced if pension plans were required to meet certain minimum standards. Minimum standards could impose vesting requirements, benefit levels, and requirements for survivor and disability benefits similar to or identical with those provided by Social Security.

An approach developed by the Office of Personnel Management would rely on credit transfers rather than on minimum standards to fill major gaps in Federal workers' survivor, disability, and retirement protection.

Appendix A of the full report discusses the redesigning of staff pension formulas that would be necessary if mandatory Social Security coverage were enacted. Appendix B of the full report presents examples of how Social Security benefits would be calculated under the alternatives for eliminating windfalls.

Section 5. Federal Employees and Social Security

Nine of 10 civilian jobs in the Federal Government are not now covered by the Social Security program. This chapter in the full report describes the Civil Service Retirement System's coverage, benefits, eligibility, and financing and compares them with those of the Social Security program.

This section deals with the following issues: the legal aspects of mandating Social Security coverage, the coordination goals, the levels of benefits to be maintained under a coordinated system, the costs of extending coverage, transition methods and costs, and the administrative tasks involved in implementing mandatory coverage.

Legality

Congress can enact legislation that would (1) extend Social Security coverage to Federal employees, (2) modify future accrual rates under existing Federal pension plans, and (3) restrict Social Security coverage and modifications of benefits for future service to selected groups such as new employees or employees below a certain age. These changes are permissible under the Constitution.

Coordination Goals

In developing specific options for CSRS-Social Security coordination, the Study Group tried to balance several important and sometimes conflicting objectives:

(1) Proposed modifications should not affect the benefits that current Civil Service annuitants receive.

(2) Employees eligible for immediate Civil Service retirement should not be affected.

(3) There should be no reductions in benefits already accrued and no unreasonable reductions in expected benefits for current employees.

(4) Costs to the Federal Government of a modified CSRS together with the Government's contributions to Social Security should approximately equal the Government's costs for the current CSRS.

(5) The modified CSRS should be as simple to administer as is feasible.

(6) Where possible, modifications of CSRS should be consistent with Internal Revenue Service regulations now imposed on private employers concerning integration of pension benefits.

Benefit Design and Costs

The Study Group examined three principal approaches to coordination of CSRS and the Social Security program:

The **constant-benefit approach** would, on average, maintain existing benefit levels for a selected group of "targeted" employees—those with full careers (42 years) in Federal service and final salaries of $20,000. Compared with the current system, the constant-benefit approach would result in higher income replacement rates for full-career employees with salaries below this level and lower replacement rates for persons above this level. Several modifications of the CSRS benefit formula would be possible under this approach, with slightly different effects on the income distribution of benefits. Under each modification, total costs to the Federal Government would be somewhat lower than costs under the current CSRS, primarily because of declining costs of ancillary benefits.

A second approach—called the **modified OPM approach** because the basic formulas were developed in consultation with the Compensation Group in the Office of Personnel Management—would provide somewhat more generous alternative CSRS formulas. The targeted final salary would be $30,000 rather than $20,000. High-income employees would lose less and low-income workers would gain more under this modified OPM approach than under the constant-benefit approach. This approach would cost slightly more (0.1 percent to 2.3 percent of payroll) than the current CSRS.

Because both these approaches would result in an increase in retirement benefits for lower income employees and a reduction for higher income employees, an optional **thrift plan** might be offered to offset the effects of the formulas for high-income employees. A thrift plan would provide a contributory, supplemental annuity for individual employees. The Government could match employee contributions fully or in part; an individual's accumulated contributions and investment earnings would be collected at retirement. High-income employees could use this option to obtain income replacement rates comparable to those now produced by CSRS. Depending on the specified matching rate and level of employee participation, a thrift plan combined with a constant-benefit CSRS modification could cost about the same as the current CSRS.

Under a third coordination approach, the existing CSRS benefit formula would be retained, but the resulting benefit would be reduced by the full amount of Social Security benefits attributable to Civil Service employment. This approach would maintain the current CSRS benefit structure intact by completely neutralizing the distributional effects of Social Security benefits. The proportionately higher Social Security benefits to low-income employees would be completely offset by the coordinated CSRS plan. CSRS would pay proportionately higher benefits to high-income employees to offset the proportionately lower benefits paid by Social Security. This **100 percent offset approach** is contrary to Internal Revenue Service integration regulations, would be administratively complex, and would require a complicated and potentially inequitable attribution of Social Security benefits. The cost would be about the same as the current CSRS.

Transition Options

Granting full, retroactive Social Security coverage to Federal workers not already eligible to retire was dismissed on administrative, cost, and equity grounds. Covering all future service of employees not yet eligible to retire would provide new windfalls for 24 percent of Federal employees while reducing windfalls for 56 percent. Exempting current employees who are fairly close to retirement and covering all future service for others would virtually eliminate contribution and coverage gaps, would protect current pension accrual rates for current employees, and would gradually phase out windfalls for current workers.

Extending Social Security coverage only to future employees would be the slowest of the options in achieving the goals of coverage, but would be the most acceptable plan to Federal workers opposed to coverage. Covering all future workers while permitting current employees to select coverage might generate the least ill feeling among workers. Moreover, if future windfalls were eliminated, some current workers would benefit by opting for Social Security coverage.

Administrative Implementation

To implement mandatory coverage, the Federal Government would have to alter its bookkeeping methods to begin withholding employee and employer Social Security taxes. Depending on the coordination formula chosen, other tasks would also be necessary. Among them are (1) developing methods of acquiring accurate wage histories; (2) reviewing and reformulating procedures periodically so that the new CSRS could maintain the desired benefit levels by responding to changes in the Social Security program; (3) establishing procedures to verify eligibility for disability under the Social Security system; and (4) maintaining a dual system of employee records while employees who have benefit accruals under the "old" system are still working.

Section 6. State and Local Government Employees and Social Security

Seven of 10 employees of State and local governments are covered by Social Security; virtually all these employees are also covered by State or local plans for public employees. State and local government workers who are not covered by Social Security are generally covered by public employee retirement systems sponsored by their employers.

This section describes provisions for coverage, benefits, eligibility standards, and financing and compares covered and noncovered public employee retirement systems. The section then deals with the legal issues concerning mandatory Social Security coverage of State and local employees, the design of coordinated benefit formulas, the costs of various approaches, the transition methods and costs, and the effects of mandatory Social Security coverage on the formation of capital.

Public Employee Retirement Systems

Public employee retirement systems now cover approximately 10 million State and local government employees, protecting them and their survivors against income loss due to retirement, disability, or death. For approximately 72 percent of State and local employees, Social Security is an important addition to this protection. For the remaining 28 percent, however, the public employee retirement system constitutes the only income protection.

Covered and noncovered systems have similar characteristics. Most participants are covered by retirement benefit formulas based on a percentage of pay and years of service, and most receive limited disability and preretirement and postretirement survivor protection through their pension plans. Limited portability is available, but usually only to other governmental units within the same State. Benefits are adjusted to the cost of living after retirement, but the adjustments often are not automatic or are set at a level—typically 3 percent—well below the inflation rate of recent years.

Although provisions of covered and noncovered systems are similar, participants in systems covered by Social Security generally have substantially superior protection. Data from the Pension Task Force of the House of Representatives indicated that in 1976, annuitants in covered systems received a combined benefit 20 to 60 percent higher at retirement than did annuitants in noncovered systems. Furthermore, because Social Security is fully indexed, the purchasing power of benefits was also sustained. In all, covered employees pay more to the plan and to Social Security than noncovered employees pay.

Employees in six statewide systems—Colorado, Louisiana, Maine, Massachusetts, Ohio, and Nevada—are not covered by Social Security. In addition, several large municipal pension plans and teacher retirement systems are not coordinated with Social Security. In many jurisdictions, safety officer plans remain outside the Social Security system. More than half of all noncovered workers are concentrated in four States—California, Ohio, Illinois, and Massachusetts. However, the effects of mandatory coverage would be felt to some degree by workers in all but 11 States.

Legal Issues

Extending Social Security coverage to State and local government employees would raise competing constitutional claims. Congress may have power to extend coverage under article 1, section 8, of the Constitution, which grants Congress the power to levy taxes, to spend for the general welfare, and to regulate commerce. States might challenge coverage as an encroachment on their sovereignty, which is protected by the 10th amendment. Congress might override State sovereignty through enforcement of the equal protection clause of the 14th amendment. How these competing constitutional claims would be resolved is unclear.

Coordinated Retirement Benefit Design

Mandatory Social Security coverage would probably encourage redesign of public employee retirement benefit formulas. The formulas chosen would depend on the decisions of employees, elected officials, pension administrators, and taxpayers in the jurisdictions involved. Clearly, the decisions would be unique to each location; predicting the outcome of this process is not possible. Therefore, the Study Group evaluated several alternative benefit designs that might be considered for the newly coordinated systems.

To explore plausible alterations of current benefit formulas to reflect Social Security coverage, the Study Group relied heavily on the work of two outside groups:

(1) The first group included State and local pension plan actuaries who were retained to analyze the effects of mandatory coverage on their plans. The 25 plans in this study encompass a wide range of benefit provisions and vary in size from fewer than 20 to more than 100,000 members. The actuaries' sensitivity to the factors that might affect their jurisdictions' decisions on plan alternations proved invaluable to the Study Group. (Throughout the report this group is referred to as the Actuarial Education and Research Fund—AERF—group.)

(2) The second group consisted of an actuarial firm currently working in cooperation with U.S. Government agencies to study public employee retirement systems. This group estimated the potential effects of coverage of 22 large plans that now include more than half of all noncovered State and local government employees. The interagency project applied standardized economic assumptions and cost calculations to their sample plans. (Throughout the report this group is referred to as the interagency group.)

Both groups were asked to design new, coordinated retirement benefit formulas that replicated, to the extent possible, current net replacement rates—that is, constant-benefit formulas. Both groups designed constant-benefit formulas to the add-on, step-rate, and offset types.

In designing the constant-benefit formulas, the two groups attempted to maintain the net income replacement rate provided during the first year of retirement because employee groups concerned would not accept a substantial reduction in first-year retirement benefits. Since cost-of-living protection would be improved in a coordinated program, maintaining first-year benefits means there would be a large jump in the value of total lifetime benefits. The interagency group, for example, found that in their constant-benefit designs, the present value of lifetime benefits at retirement increased an average of 10 percent, given 5 percent price inflation, and increased 37 percent at 10 percent price inflation. This increase results directly from replacement of part of the initial public pension benefit by a fully indexed Social Security benefit. Participants would also enjoy improved disability and preretirement and postretirement survivor protections. In both constant-benefit designs, many who now have early retirement options would receive special supplements intended to bolster retirement income until Social Security benefits became payable at 62.

In addition to designing constant-benefit formulas for the new, coordinated plans, each group was asked to perform a separate, second task. State and local actuaries in the AERF group were asked to design a coordinated formula that they believed would "most likely" be adopted if Social Security coverage were extended. In some cases the actuaries selected one of the formulas developed for the constant-benefit analysis; in others they chose an even more generous formula. (Some pointed out, however, that if the coverage extension were to apply to new employees only, a somewhat less generous formula might be enacted.)

In contrast, the second task assigned to the interagency study's actuaries involved developing benefit projections for the 22 plans in this study, using a "most typical" (or "standard") formula characteristic of public pension systems already covered by Social Security. Generally, these benefits would be the most generous of all the possibilities considered. Although many currently covered systems established benefit and employee contribution rates some time ago, it is useful to determine what costs and benefits would be involved if the newly covered systems were to be designed similar to currently covered ones.

The result of these analyses of coordinated benefit formulas showed that formulas can be devised that maintain—or improve—initial retirement benefits for any selected target group of public pension members. At the same time, cost-of-living and ancillary protections would be improved.

Cost of Coordinated Formulas

The cost of any retirement formula and plan composition can be expressed as "entry-age normal cost." Normal cost is the level percentage of salary needed to fund each employee's benefit by retirement date, if contributed annually from time of employment. If this figure is aggregated across employee categories and adjusted for employee resignations, disabilities, and deaths, the result becomes the plan's normal cost. Additional unfunded liabilities can be amortized over a standard period, typically 40 years. By using these standardized cost calculations for all plans, the Study Group estimated the cost of mandatory coverage. After coverage, normal costs would be lower than the current plan's costs because each plan's formula would be redesigned to take account of Social Security benefits. On average, in the constant-benefit formulas of both groups, normal costs after coverage (as a percentage of payroll) would decline to between one-half and two-thirds their former level. Postcoverage costs would be heavily influenced by special early-retirement supplements for systems in which early retirement is common—especially police and firefighter plans. These normal costs are in addition to the new Social Security payroll taxes assumed by employers and employees. The net effect of lower normal costs combined with scheduled payroll taxes would be an average increase of about 5 percent to 10 percent of payroll in the constant-benefit formulas, or an increase of 33 percent to 62 percent over current normal costs. Cost increases would be even more significant for the "most likely" and "most typical" or "standard" formulas because these formulas are more liberal.

These cost increases could be divided between employers and employees in many ways. For example, in the constant-benefit cases, it was intended that employees would experience minimal change from the current systems. Therefore, the working hypothesis was that jurisdictions, recognizing the new burden of the Social Security tax, might make the new plan noncontributory—or at least lower employee contribution rates. However, in the "most typical" projection, employees would pay 4 percent of their pay into the fund in addition to Social Security, the same percentage as the average contribution in currently covered systems. In the "most likely" projection, the State and local actuaries speculated that the total employee contribution might increase by 2 percent to 4 percent of gross pay.

Current public employee retirement protection and new Social Security coverage are not duplicative in several areas. The cost impact of mandatory coverage cannot be ascribed directly to specific provisions. Among the most important factors contributing to the cost increases are strengthening the cost-of-living protection; reducing forfeitures that occur when vested or nonvested employees resign (since part of retirement protection will become fully portable); designing special supplements for retirement before age 62 (especially in police and firefighter plans); and improving health insurance and disability and survivors' benefits.

Transition Considerations

The transition problems associated with mandatory coverage are more challenging at the State and local levels than at the Federal level. Elected officials, plan administrators, and employees need considerable time to determine the appropriate design for newly coordinated formulas and to devise approaches for meeting the higher costs. The Study Group concluded that at least 4 years would be required for this process.

Two transition approaches were analyzed: coverage of new employees only and coverage of current workers plus all future employees. Even under the second approach, some exemptions would probably be granted for current employees nearing retirement or meeting certain age and service criteria.

Covering only new employees would mean that erasing all windfalls and gaps resulting from absence of mandatory coverage could take up to 40 years. Nevertheless, this approach may be preferred. The cost increases resulting from mandatory coverage would be phased in gradually. The actual transition time would depend on the plan's turnover rate; cost increases during the first several years would be minimal. Moreover, this approach might permit changes in the coordinated retirement benefit formula that might be difficult to enact if current employees were also affected. Legal challenges and administrative problems (especially design and funding of hold-harmless provisions) would also be minimized. Current employees might be permitted to elect Social Security coverage under this approach.

In contrast, covering current employees as well as new employees would impose sharp cost increases; the Study Group estimates that in the first year alone half the plans would face increases of between 2 percent and 7 percent of payroll. The goals of mandatory coverage would be achieved quite rapidly but at considerable cost to the employing jurisdictions.

In both transition scenarios developed by the Study Group, total pension costs in some years would exceed the costs of the new, coordinated formula. These additional costs would result from the amortization of liabilities accrued under the earlier, noncoordinated formula. Except when a fund's reserve status is precarious, some flexibility would exist for managing accrued liabilities.

Impact of Social Security Coverage on Capital Formation

Extension of Social Security coverage to State and local government employees would not be expected to disrupt capital formation in the United States. Extension of coverage would reduce the level of contributions now flowing into noncovered State and local plans, but the reductions would be small and would probably occur gradually. Compared with the potential effects of other long-term developments, particularly changes in plan funding and investment strategies, the effects of extending Social Security coverage to all State and local government employees seem relatively small and manageable.

Section 7. Private, Nonprofit Organizations and Social Security Coverage

Most well-established, private, nonprofit institutions participate voluntarily in the Social Security program. Therefore, as many as 9 out of every 10 positions in these organizations are now covered.

Empirical data on employment in the nonprofit world are hard to obtain and assess, but the Study Group made several conclusions from its investigations.

Mandatory coverage would improve the income protection of noncovered workers and would present no special administrative difficulties for employers. However, because much employment in the nonprofit sector is sporadic, and because considerable nonprofit activity occurs without any contact with the government, it would be hard to enforce mandatory coverage for all nonprofit enterprises. Religious organizations might resist mandatory participation on first amendment—free exercise of religion—grounds. Secular nonprofit organizations might have similar—freedom of association—grounds for opposition.

Section 8. Perspective on the Feasibility and Desirability of Mandatory Social Security Coverage

The Study Group was specifically charged with the task of evaluating the "feasibility and desirability" of extending Social Security coverage to currently exempted employees.

The Study Group determined on the basis of legal, administrative, fiscal, and transition criteria that it would be feasible to expand Social Security coverage.

Legal criteria. Extending Social Security coverage to noncovered workers would raise several legal issues, which vary for each of the noncovered groups. If Social Security coverage were extended to civilian employees of the Federal Government, few legal problems would probably ensue. Congressional power to mandate coverage is clear. How the legal issues would be resolved if Social Security coverage were extended to State and local government employees is less clear. Opponents and proponents of coverage could present competing constitutional claims that would require judicial resolution. If coverage were extended to employees of nonprofit organizations, religious and secular organizations wanting to oppose coverage could also base their legal claims on the Constitution.

Administrative criteria. During the transition period, some added administrative complexity could be expected. The extent of the burden would depend on the approach selected to coordinate staff pension systems. Administrators also would have to choose between two methods as the current pension system was closed and the new one became effective. If only future employees were covered, a dual system would have to be administered. Coverage of only part of the current work force or of future workers only would not require establishment of separate pension trust funds for these systems.

Fiscal criteria. The fiscal implications of extending coverage to Federal workers are relatively neutral from the perspective of the consolidated Federal budget. Both Social Security and the Civil Service Retirement System are funded within the same budget. The effects are more evident, however, when separate accounts are considered. By covering Federal employees, the Social Security program would receive new monies and assume new obligations. However, coverage of Federal workers would lead to reduced revenues for CSRS and commensurately reduce pension obligations under the coordinated system. Covering Federal employees would mean the gradual elimination of Social Security windfalls to CSRS annuitants. Coverage would also lead to net gains for the Social Security program as contribution gaps were closed and as higher income public employees were affected by the redistributive aspects of Social Security.

At the State and local levels, expanded Social Security coverage would mean elimination of another $750 million to $1 billion in benefit and contribution inequities. Expanded coverage would involve diverting some pension contributions from locally administered pension funds into the Social Security trust funds. Even when the present pension formula was redesigned to reflect Social Security benefits, combined pension costs would generally increase. In the constant-benefit case, for example, the long-term cost increase typically falls between 5 and 10 percent of payroll. When the new costs associated with Social Security coverage are considered in the resulting coordinating plans, however, pension costs generally would not be higher in the affected jurisdictions than in localities already covered by Social Security.

Coverage would mean an additional cost for nonprofit organizations that have not waived their exemptions from Social Security coverage. The cost of Social Security may become prohibitive for short-term, nonprofit organizations established to reach a goal within a specific period. The paid employment that exists in such organizations hardly constitutes full-time career employment. For these groups, some threshold of hours or wages might be established for determining when coverage was required.

Transition criteria. At the Federal level, the transition to Social Security coverage would only minimally affect costs, whether the transition included current workers or only future employees. Costs of the new system would be similar to those of the current system. The optimal transition would depend on the trade-offs involved in maintaining current employees' satisfaction with the existing pension system while eliminating problems resulting from lack of coverage.

For State and local pension systems, the transition to coverage would generally be more costly. Most of these systems would have higher ultimate costs when the payroll tax is included; they would need new ways to finance a higher level of pension obligations. Covering current workers would result in a faster transition to the more expensive system than would be the case if coverage were extended to new employees only. Beyond this option, the means available to a pension system to phase in increased costs are contingent on the current plan's funding level. Pay-as-you-go systems would have to assume Social Security obligations for current workers while paying accrued obligations from operating funds. For systems with some advance-funding, the problem would be less critical.

The Desirability of Alternative Solutions

Opponents of mandatory Social Security coverage have argued that the problems should be resolved by alternative means. No alternative solves all the problems discussed in this article without introducing new problems.

If the windfall reduction options were implemented, the costs of eliminating windfalls would be borne only by the worker; coverage gaps would remain.

If a transfer-of-credit plan were implemented, the employer and employee would share the cost of reducing windfalls and gaps. This plan would raise the costs of pensions for noncovered employment. A two-way credit-transfer plan would be both administratively cumbersome and contrary to established Social Security provisions. Mandatory, one-way credit-transfer plans would introduce inequities for noncovered workers, unless they were coupled with stringent vesting requirements for public employee retirement systems. One-way credit transfers would not necessarily eliminate windfalls.

If minimum standards for public retirement systems were implemented, some of the portability problems and benefit protection gaps could be reduced. This plan would result in higher public retirement system costs.

Implementing either a mandatory transfer-of-credit program or minimum standards would require Federal legislation affecting State and local pension systems. This legislation would almost certainly encounter the same legal tests as mandatory Social Security coverage.

The Desirability of Expanded Social Security Coverage

The desirability of expanding Social Security coverage depends on one's perspective. At the public hearings on mandatory coverage held by the Study Group, nearly all the testimony came from individuals receiving public plan annuities, from public employees, or from their representatives. These individuals' pension systems would be covered if Social Security participation were mandated. Their testimony was overwhelmingly negative. Noncovered employees' groups maintain that many of their members already have Social Security coverage through alternative employment and would not receive commensurately larger benefits based on the additional contributions they would have to make if coverage were mandated. Rather than extend coverage, they suggest that any inequitable subsidies being provided by Social Security should be modified.