Introduction

About 28 percent of state and local government workers (SLGW) participate in retirement plans that are excluded from Social Security coverage.

This paper:

• discusses ways to improve federal oversight of these plans; and

• explores the need to strengthen benefit protections for employees not covered by Social Security.
Background

When the Social Security Act was originally enacted in 1935, SLGW were excluded.

- Beginning in 1950, amendments expanded options for coverage to more and more groups of SLGW
- As of 2015
  - nearly 16.0 million SLGW (72%) were covered
  - about 6.4 million SLGW (28%) were not covered

Background

Coverage varies widely by state (2015)

Source: Based on data obtained from SSA (2018).
Background

Most research has focused on the pros and cons of proposals that would require mandating coverage:

• **Pro**: help finance Social Security, promote greater equity, simplify administration, and providing better protection for uncovered workers

• **Con**: added costs to uncovered programs and risk of lowering benefits

Government at Risk

Determining whether SLGW are covered by Social Security is challenging:

• Coverage status can vary based on a worker’s position and hire date, as well as employer

• “Section 218 Agreements” are often hardcopy documents annotated with many changes

• Oversight responsibilities are split between IRS and SSA
Government at Risk

IRS is responsible for ensuring correct Social Security taxes are paid for all employees—both public and private, but –

• IRS’s reconciliation process does not work well for uncovered public employees
• Errors may only be discovered by chance

Government at Risk

SSA is responsible for ensuring correct Social Security benefit amounts are paid to retirees, but –

• Required offsets for uncovered employment make this challenging
• Offset provisions have been identified as the leading cause of the more than $1.8 billion in improper payments in 2017
Workers at Risk

IRS regulations require uncovered plans to provide a minimum benefit comparable to Social Security.

- Safe harbor and other regulatory provisions do not uphold this standard
- Various hypothetical scenarios illustrate the extent to which benefits could fall short

Workers at Risk: Analysis

The comparison of minimum required benefits and Social Security benefits for comparable work was conducted in several steps:

1 – Creation of hypothetical work history scenarios
2 – Calculation of Social Security benefits
3 – Calculation of minimum monthly benefits for defined benefit (DB) plans
4 – Calculation of estimated monthly annuity payments for defined contribution (DC) plans
Workers at Risk: Analysis

Most SLGW have retirement plans that are DB plans (pensions), but the number of DC plans (like 401(k)s) is growing.

Source: Based on BLS data (March 2017).

Workers at Risk: Analysis

1 – Creation of hypothetical work history scenarios

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<th>Numbers Assigned to Hypothetical Work History Scenarios</th>
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2 – Calculation of Social Security benefits

Workers at Risk: Analysis

3 – Calculation of minimum monthly benefits for DB plans

For each scenario, benefit calculations were made based on IRS’s minimum benefit requirements for two types of DB plan formulas:

• A “high-3” formula, using a 1.5% factor
• A “high-5” formula, using a 1.6% factor

Workers at Risk: Analysis

4 – Calculation of estimated monthly annuity payments for DC plans

For each scenario, annuity payments were calculated based on the amount of assets accumulated using IRS’s minimum required contribution rate of 7.5%.

• Two final DC account balances were calculated, based on a rates of return of 8% and 5%, compounded annually.
• An online tool was used to estimate a monthly payment from a lifetime annuity purchased with the account balance.
Results: DB Plans

In general, the minimum benefit safe harbor formulas produced a benefit greater than the Social Security benefit for comparable service in about one-third of the 60 scenarios.

Among those in the lowest income quartile:

Among those in the highest income quartile:

Risks are greatest for those working for government entities facing financial distress—benefits could be reduced and no safety net.
Results: DC Plans

In general, the minimum benefit rules for DC plans resulted in a lifetime annuity monthly payment greater than the Social Security benefit for comparable service in about one-fourth of the 60 scenarios.

Among those in the lowest income quartile:

Due to market risk, those with DC plans have no assurance that their account balance will be sufficient to purchase an annuity comparable to the lifetime Social Security benefit.
A New Approach

To improve government oversight:
Instead of verifying proper withholding and benefit payments based on states’ Section 218 Agreements, require government employers to provide a list of their employees who are not participating in Social Security, updated annually.

To strengthen minimum benefit requirements:
Require government employers to provide non-covered workers a calculation of the benefits they would have received from Social Security for comparable service, and if greater, they should be required to make up the difference, with payments guaranteed by the state.

Conclusion

Neither the federal government nor the excluded workers are being served well by the status quo.

Government employers should be willing to
• Report which of their employees are excluded from Social Security coverage
• Ensure benefits actually received are at least comparable, guaranteed by the state

If not, they should not be excluding their workers from Social Security coverage.
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